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Wholesale power market liquidity: statutory consultation on the 'Secure and Promote' licence condition

Consultation

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Overview:

Ofgem's liquidity project seeks to ensure that the wholesale electricity market support effective competition, delivering benefits to consumers in terms of downward pressure on bills, greater choice and better service. We are concerned that poor liquidity in the wholesale electricity market is posing a barrier to effective competition, thereby preventing consumers from fully realising the benefits of competition. While we have seen some recent improvements, particularly in near-term markets, this progress has been insufficient. As such, we intend to intervene in the market to improve liquidity.

We are proposing to introduce a new special licence condition into the generation licences of the eight largest electricity generating companies – Centrica, Drax, EDF Energy, E.On, GDF Suez, RWE npower, SSE, and ScottishPower. The licence condition aims to improve access to the wholesale electricity market by requiring these companies to follow a set of 'Supplier Market Access' rules when trading with small independent suppliers. It also aims to ensure that the market provides the products and price signals needed to compete effectively through a market making obligation on the six largest vertically integrated companies – Centrica, EDF Energy, E.On, RWE npower, SSE and ScottishPower.

We received a number of responses to policy proposals we consulted on in June and these have informed our final policy design. We have drawn up a draft licence condition to implement our policy. We are seeking views from interested parties on the draft licence condition . Subject to these responses, we will make the necessary changes to licences in early 2014.

Context

Ofgem's principal objective is to protect the interests of present and future consumers.[1] In accordance with this objective, we want to ensure that liquidity in the GB wholesale power market is sufficient to underpin well-functioning, competitive generation and supply markets. Under the Third Package[2], we also have a duty to promote integrated European energy markets. Our view is that improvements to wholesale power market liquidity will support this objective.

This Statutory Consultation represents the latest phase in our liquidity project, through which we have been monitoring the wholesale market and considering interventions that could improve liquidity.

Alongside the Retail Market Review, it forms part of our efforts to ensure that consumers get the best possible deal from energy markets. We have previously maintained that we would prefer to see industry initiatives deliver improvements. However, because such initiatives have not delivered the improvements we need to see, we now intend to intervene.

Associated documents

Notice under Section 11A(2) of the Electricity Act 1989 (20 November 2013)

Draft Guidance - Liquidity in the Wholesale Electricity Market (Special Condition AA of the electricity generation licence) (20 November 2013)

Wholesale power market liquidity: statutory consultation on the 'Secure and Promote' licence condition - Impact Assessment (20 November 2013)

Wholesale power market liquidity: final proposals for a 'secure and promote' licence condition (12 June 2013, ref 88/13)

[1] This includes the interests of consumers in the fulfilment by Ofgem, when carrying out its functions as designated regulatory authority for Great Britain, of the objectives set out in Article 40(a) to (h) of the Gas Directive and Article 36(a) to (h) of the Electricity Directive.
[2] The term "Third Package" refers to Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 (Gas Directive) and Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 (Gas Directive) and Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 (Electricity Directive), concerning common rules for the internal market in natural gas and electricity respectively.

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Executive Summary

Our liquidity project aims to improve competition in the wholesale electricity market by removing barriers which make it difficult to trade electricity. Alongside initiatives to make energy retail markets simpler, clearer and fairer, it is a key part of our work to ensure that consumers get the best possible deal.

We have consistently found that GB wholesale electricity market liquidity is poor, particularly for products traded ahead of when they will be supplied (eg for future months or seasons). This is inhibiting the ability of market participants – particularly independent market participants – to access the range of wholesale market products they need to compete effectively in the electricity generation and supply markets. We have decided to intervene to improve liquidity and ensure that consumers are able to benefit from increased competition.

In this statutory consultation we confirm our final policy position for a 'Secure and Promote' (S&P) licence condition to improve liquidity. We are seeking views on whether the licence condition reflects our policy proposals. S&P has three distinct elements:

	Objective	Proposed intervention under S&P	Licensees subject to obligation
1	**Availability of products that support hedging**	**Supplier Market Access Rules** – Rules to ensure small suppliers can access the wholesale market products they need	Centrica, Drax Power, E.ON UK, EDF Energy, GDF Suez, RWE Npower, ScottishPower, SSE
2	**Robust reference prices along the curve**	**Market Making Obligation** – Licensees must post bid and offer prices in the market, supporting price discovery and ensuring regular opportunities to trade	Centrica, E.ON UK, EDF Energy, RWE Npower, ScottishPower, SSE
3	**Effective near-term market**	**Reporting requirements** – Monitoring of near-term to ensure it remains liquid. We stand ready to intervene if necessary	Centrica, Drax Power, E.ON UK, EDF Energy, GDF Suez, RWE Npower, ScottishPower, SSE

This statutory consultation follows a consultation in June 2013 where we sought stakeholders' views on our final proposals. Overall, the response was positive, with 80 per cent of respondents broadly supportive of our proposals. The consultation also yielded a wide range of helpful feedback. We have sought to incorporate aspects of this feedback in our final policy design to improve its effectiveness.

While the overall structure and approach is the same, there are a number of key changes to the S&P licence condition that we consulted on in our June 2013 proposals. Most prominently, the market making obligation is now designed to facilitate liquidity 'windows'. These concentrated periods of liquidity will provide market participants with regular opportunities to trade and certainty over when they can trade. Liquidity windows will more effectively support the development of robust reference prices, by ensuring that there is sufficient daily market activity on which to build such prices.

We have also developed our thinking in relation to EU financial legislation, such as the proposed new version of the Market in Financial Instruments Directive. We recognise that financial legislation has the potential to have a significant impact on wholesale energy markets. We also recognise that it could interact with the S&P licence condition. The licence condition on which we are consulting today provides a mechanism whereby if a licensee considers forthcoming EU financial legislation will significantly impair its ability to comply with its market making obligations, it may make a request for us to undertake a review of the licence condition.

The licence condition and associated draft guidance we have published today represents our final view of the best approach to support liquidity. We want to ensure that the S&P licence condition fully reflects our policy objectives, and we welcome comments from stakeholders on whether it does so.

Subject to any responses to this statutory consultation, we will direct the modification to the generation licences of obligated parties to be implemented on 31 March 2014 (the date of the decision to modify the licence being not less than 56 days before 31 March).

Once S&P is in place, we will continue to monitor its effectiveness and the progress of the wholesale electricity market towards our objectives. We will share our analysis of the market with stakeholders. If necessary, we will also consult on any changes that are needed to the licence condition and its associated guidance. Apart from any review prompted by EU financial legislation, we intend to leave the licence condition in place for a significant period (at least three years) before making fundamental changes. After this period, we would expect to conduct a review of whether it remains appropriate.

1. 'Secure and Promote'

Chapter Summary

We explain why we are proposing to intervene to improve liquidity in forward electricity markets. We outline the general feedback we received on our June consultation. We then set out the next steps following the publication of this statutory consultation.

Introduction

1.1. This document is our statutory consultation on our 'Secure and Promote' licence condition to improve liquidity. It sets out our final policy design. Alongside this document we have also published:

- **A statutory notice under Section 11A(2) of the Electricity Act 1989**. This includes the full text of our proposed licence condition;
- **A draft Guidance document**. This provides guidance on interpreting the obligations set out in the licence text and other relevant information; and
- **An Impact Assessment**. This provides our updated views of the costs and benefits of our proposed licence condition.

1.2. These documents are published on our website, www.ofgem.gov.uk.

Liquidity in wholesale energy markets

Effective wholesale energy markets can deliver benefits to consumers

1.3. Consumers can benefit from competitive energy markets through downward pressure on bills, better service and greater choice. We are concerned that poor liquidity in the wholesale electricity market means it does not effectively support competition in both the generation and supply markets.

1.4. Liquidity is the ability to quickly buy and sell a commodity without a significant change in its price and without incurring significant transaction costs. A lack of liquidity can prevent consumers from fully realising the benefits of competitive markets through a number of channels:

- **Deterring entry and growth of players in the market** – Poor liquidity can make it difficult for firms to sell their output or source the power needed to supply their customers. This limits the ability of new firms to enter and of existing independent firms to grow. This barrier to entry and growth removes a competitive threat to incumbent firms.

- **Inhibiting competition between existing players in the market** – Poor liquidity in the electricity wholesale market limits opportunities to trade, reducing the scope to identify optimal hedging strategies that provide customers with the best possible deal. This can make it difficult for firms to increase their market share. It could also encourage business models that reduce the need to trade in the wholesale market, such as vertical integration and long-term contracts. Poor liquidity therefore inhibits competition between incumbent players in the market.

- **Weakening price signals that help to ensure security of electricity supplies –** To make decisions about investment in new generating plant and when to carry out maintenance, generators need price signals from a robust and transparent forward market. Poor liquidity may obscure or weaken these price signals, potentially having a negative impact on the security of supply.

1.5. It is therefore vital to ensure that wholesale markets are liquid, so that consumers can be confident that they are getting the best possible deal.

1.6. Poor liquidity can be self-reinforcing. Poor availability of products and price signals can deter firms from trading in the market, which then further reduces the availability of products and prices. The market therefore becomes locked in a low-liquidity equilibrium. There may be insufficient incentives for individual firms to break free from this equilibrium. However, an external shock – such as a regulatory intervention – can set liquidity on an upward path. As firms become confident that products will be available at robust prices, they will increase their participation in the market, further improving liquidity. A more detailed discussion on the effects of poor liquidity and the scope for regulatory intervention to improve liquidity can be found in chapter one of the impact assessment[3].

June consultation

1.7. In June[4] 2013 we set out our final proposals for a 'Secure and Promote' (S&P) licence condition. We stated our view that these proposals would best meet our liquidity objectives. These objectives reflect key characteristics needed in the wholesale market in order to effectively support competition:

[3] See Ofgem (2013), Wholesale power market liquidity: statutory consultation on the 'Secure and Promote' licence condition – Impact Assessment, chapter one, for a more extensive discussion of liquidity is and why it is important.
See also paragraphs 1.7 to 1.12 of Ofgem (2009), Liquidity in the GB wholesale energy marketshttps://www.ofgem.gov.uk/ofgem-publications/40485/liquidity-proposals-gb-wholesale-electricity-market.pdf (ref 62/09).

[4] Ofgem (2013), Wholesale power market liquidity: final proposals for a 'secure and promote' licence condition (ref 88/13).

- availability of products that support hedging;
- robust reference prices along the curve; and
- an effective near-term market.

1.8. Overall, a clear majority of responses were supportive of the S&P intervention. However, there were divisions between types of stakeholders: most proposed S&P licensees raised concerns with elements of the proposals, while independent firms were generally supportive. Opposition from potential licensees was mainly focused on the Market Making obligation, with few expressing serious reservations about the Supplier Market Access (SMA) rules.

1.9. There was general agreement with our conclusion that liquidity in the wholesale electricity market remains poor and significant support for the policy design set out in our June consultation. Respondents took advantage of the more advanced stage of the proposals and provided feedback on the detail of the design. We have made a number of refinements to the detail of our proposals to address concerns and incorporate improvements raised by stakeholders.

Next steps

1.10. Appendix 2 of this document contains a statutory notice of our proposal to modify certain electricity generation licences under Section 11A(2) of the Electricity Act 1989. This statutory modification notice proposes to implement the design set out in this document.

1.11. Subject to any responses to the statutory consultation, we will direct the modification to the generation licences of obligated parties to be implemented on 31 March 2014 (the date of the decision to modify being not less than 56 days before 31 March). It should be noted that the changes to the licence modification process as a result of the implementation of the Third Package mean that the consent of licensees is no longer required in order for us to implement the modification. However, following publication of the decision to modify from the Authority, relevant parties[5] have 20 working days in which to seek leave to appeal our decision to the Competition Commission (CC).

Post implementation

1.12. We will receive quarterly reports from S&P licensees to demonstrate their compliance with the licnece condition. We will monitor their performance against the licence condition and will report on progress.

[5] The relevant parties who can seek leave to appeal are: a relevant licence holder, any other person who holds a licence of any type under the Gas and Electricity Acts whose interests are materially affected by the decision, a qualifying body or association representing a person in the two previous groupings, and Consumer Futures.

1.13. Apart from any review prompted by EU financial legislation we intend to leave the licence condition in place for a significant period (at least three years) before making fundamental changes. After this period, we would expect to conduct a review of whether it remains appropriate.

2. Legal structure of Secure and Promote

Chapter Summary

We set out the legal structure of our intervention and who it will apply to. We outline the feedback we received on our consultation proposals and how we have taken this into account.

Legal approach to S&P

2.1. In our June 2013 consultation we set out the legal structure for introducing a 'Secure and Promote' licence condition. We noted that this would be a special condition inserted into the generation licences of obligated parties, containing three schedules:

- Schedule A – Supplier Market Access Rules
- Schedule B – Market Making obligation
- Schedule C – Reporting requirements.

2.2. We also noted that we intended to publish guidance to provide further clarity on the actions licensees would be expected to perform.

2.3. The consultation set out the factors considered in deciding which licensees should face obligations. These are:

- the structure of the generation and supply markets
- the key players in the market
- licensees' capability to meet the obligations at proportionate cost and risk
- the need to ensure that the intervention is effective.

2.4. Based on these factors, we set out that the following licensees would face the obligations:

Figure 1 – S&P licensees

Supplier Market Access rules		Market Making obligation	
Centrica	GDF Suez	Centrica	RWE Npower
Drax Power	RWE Npower	EDF Energy	ScottishPower
EDF Energy	ScottishPower	E.ON UK	SSE Generation
E.ON UK	SSE Generation		

Stakeholder feedback

2.5. Respondents generally welcomed the legal structure, in particular the move to clarify the detail of the obligations within a licence condition, rather than through a separate "Trading Requirements Document".[6] However some concerns were raised:

- Some respondents (notably obligated parties) disagreed with our proposal to implement using a special rather than standard licence condition
- Some respondents requested greater clarity around the circumstances in which the obligation might be removed from existing parties or imposed on new parties
- Some respondents sought clarity on how asset disposals would be affected

Our final position

2.6. We continue to consider that a special condition applying to specific licensees is more appropriate than inserting a standard condition with qualifying thresholds into all generation licences. This decision is based on a review of the rationale which we set out in our June 2013 document[7]. We maintain that the decision on which parties should be subject to S&P is best made based on a range of factors considered together, rather than by a single threshold figure. Having a standard licence condition with mechanistic thresholds:

- would be unlikely to improve the effectiveness of the intervention;
- might impose unnecessary costs on the industry (for example, through drawing in more parties to the obligation than would be necessary to meet our liquidity objectives); and
- could give rise to perverse incentives where licensees came close to meeting any pre-determined threshold.

2.7. Secure and Promote will therefore be implemented via a special condition inserted into the generation licences of the firms set out in figure 1, above. (For the avoidance of doubt, the obligation only needs to be met once by each group).

2.8. In response to requests for further certainty around the application of the obligation in the future, chapter one of the Draft Guidance document[8], published alongside this statutory consultation, sets out the factors that the Authority would

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[6] As proposed in our original consultation on 'Secure and Promote': Ofgem (2012), Wholesale power market liquidity: consultation on a 'Secure and Promore' licence condition (ref 163/12).
[7] Ofgem (2013), Wholesale power market liquidity: final proposals for a 'secure and promote' licence condition (ref 88/13).
[8] Ofgem (2013), Liquidity in the wholesal electricity market (Special Condition AA of the electricity generation licence): Draft Guidance.

consider, and the process it would undertake, prior to making changes to the list of licensees. The factors that the Authority would take into consideration include the individual circumstances of licensees and impacts on the effectiveness of S&P in meeting our liquidity objectives.

3. Supplier Market Access rules: updated design

Chapter Summary

We set out the changes we have made to the design of the Supplier Market Access rules following feedback from our June consultation. These changes include refining the detail of the rules in relation to credit, pricing, and responding to trading requests.

Supplier Market Access rules: rationale

3.1. We are concerned that existing wholesale market arrangements create barriers for independent suppliers. Independent suppliers face problems when setting up trading agreements, through which they can access the wholesale market. They also face problems when agreements are in place, for example by being unable to access sufficiently small clip sizes. This inhibits the ability of existing independent suppliers to compete with the large vertically integrated suppliers, and makes it difficult for new independent suppliers to enter the market.

3.2. The Supplier Market Access (SMA) rules seek to address these barriers, building on the efforts already made by some market participants to improve their approach to trading with independent suppliers.[9] Independent suppliers can apply[10] to Ofgem to become an 'Eligible Supplier' and thereby benefit from the SMA rules. The SMA rules set out the minimum standards that Eligible Suppliers should expect when negotiating trading agreements with proposed S&P licensees. In doing so they support our first liquidity objective: the availability of products that support hedging.

Key design changes

3.3. The SMA rules received support from a wide range of stakeholders in response to our June 2013 consultation. We received some useful feedback on the detailed design, which has helped us to refine the detail of the rules in relation to credit, pricing, and responding to trading requests. The rationale for the changes are described below. The full design of the SMA rules is set out in chapter 6.

[9] The aim of the Supplier Market Access rules is set out in more detail in our June 2013 consultation. Ofgem (2013), p19-20: Wholesale power market liquidity: final proposals for a 'secure and promote' licence condition

[10] The process for applying to become an Eligible Supplier is set out in our associated draft Guidance Document. Ofgem (2013), Liquidity in the wholesal electricity market (Special Condition AA of the electricity generation licence): Draft Guidance.

Responding to trading requests

3.4. This rule aims to ensure that Eligible Suppliers are not treated as a lower priority when making a request for a trading agreement (known as a GTMA).

3.5. Some stakeholders suggested some modifications in response to our consultation. They argued that the rule that stipulates that requests from Eligible Suppliers for a trading agreement should be checked to ensure that all relevant information had been received within two working days presented a significant compliance risk for licensees. They suggested that this length of time would be insufficient.

3.6. The intention of this rule is to provide reassurance to Eligible Suppliers that their request is being dealt with. To address stakeholders' concerns we have removed the need to confirm that all necessary information has been received within two working days. Instead licensees will simply have to confirm receipt of the request at this point.

3.7. A further change to this rule is to insert a provision which 'stops the clock' when licensees are waiting for additional information from the Eligible Supplier. Providing that the licensee has documented the time spent waiting for the Eligible Supplier to provide complete information, it will not be counted towards its response time. This change will mitigate the compliance risk for licensees while maintaining the policy intent of the rule.

3.8. Some stakeholders also highlighted that on occasion it is necessary to carry out checks (for example an independent credit check) via a third party. While the length of time taken for a third party to carry out checks may be partially out of the licensees' control, we consider that licensees should still have an incentive to liaise with the third party to seek to expedite the process. Rather than introduce a further 'stop the clock' mechanism which would increase uncertainty for Eligible Suppliers, we have increased the length of time licensees have to issue a written response from 15 to 20 working days.

3.9. We expect Eligible Suppliers to not act in a vexatious manner. We reserve the right to remove those who do – for example by prolonging negotiations beyond a point where any agreement is possible – from the list of Eligible Suppliers maintained by Ofgem.

Credit and Collateral

3.10. The credit rule we set out in our June 2013 consultation is intended to:

- ensure that credit terms offered to small suppliers reflect the risks of trading with them;
- improve the transparency of credit decisions; and

- strike the balance between improving access for independent suppliers and maintaining the robustness of credit arrangements.

3.11. Stakeholders argued that changes to the credit and collateral rule were needed to remove the possibility of Ofgem being required to arbitrate in disputes about whether terms offered were a 'reasonable reflection of the risks of trading with the counterparty'. Stakeholders also expressed concern about how we could enforce the rule.

3.12. The intention of the credit rules is that there should be a fair, proper assessment and clear communication with Eligible Suppliers. We consider that fair assessment should lead to fair outcomes, with proportionate credit terms and collateral arrangements. Clear communication will help Eligible Suppliers understand the reasons they have been offered a certain set of terms and arrangements. It is not our intention to regulate proposed S&P licensees' risk policies.

3.13. We have amended the conditions that must be met in order for credit terms to be considered proportionate. We have focussed on a transparent process of assessment which ensures that the individual circumstances of an Eligible Supplier are considered in formulating terms for credit and collateral. We have removed wording that might imply that we would arbitrate in disputes about credit terms. This better reflects our policy intent and provides clarity on how it would be enforced.

Clip sizes

3.14. The SMA rules are intended to help Eligible Suppliers access products in small clip sizes. Some stakeholders argued that it was necessary to impose a maximum clip size on the trades allowed unde the SMA rules to mitigate the risk to licensees. We have therefore inserted a condition which limits the clip size that S&P licensees must trade to a maximum of 10MW. This has been added as a backstop and we do not expect trades of this size to be common under the SMA rules.

Fair and Transparent Pricing

3.15. We set out in our June consultation that our policy intention is for Eligible Suppliers to be able to access prices reflective of those available in the wholesale market. We also intend that licensees should offer to trade in clip sizes smaller than those typically available in the market (0.5MW compared to 5MW). A consequence of this requirement is that it potentially exposes S&P licensees to a risk from holding an open position, for example from having procured 5MW in order to service a 0.5MW trading request. In cases where the price moved unfavourably before being able to close their open position, proposed S&P licensees would make a loss on SMA trades.

3.16. Stakeholders, including independent suppliers, suggested that S&P licensees should be allowed to add a risk premium to the price quoted to account for this risk, noting that this was widely accepted as standard market practice.

3.17. We have therefore revised the pricing rule to allow licensees to add an objectively justifiable risk premium to cover the risk associated with trading in small clip sizes. The premium should be clearly linked to the underlying risk. Licensees should be able to demonstrate this link and the methodology used for calculating the risk to us, if requested.

Other consultation feedback

Product list

3.18. Some stakeholders suggested that the range of products that S&P licensees are obliged to offer under the SMA rules should be extended. In particular, they suggested the inclusion of forward block and weekend products, which they argued would help Eligible Suppliers better match the shape of a standard domestic profile.

3.19. We gave careful consideration to this. However we consider that the product list set out in our June consultation strikes an appropriate balance between delivering improvements to the market and limiting the cost and risk of the intervention to proposed S&P licensees. We are also not aware of markets where such products trade far in advance of delivery.

Scope

3.20. A number of stakeholders suggested that the scope of the SMA rules should be changed. Some stakeholders (mainly proposed S&P licensees) argued that an upper threshold of 5TWh for eligible suppliers is too high. They suggested that this should be aligned with the generation threshold of 1TWh. Other stakeholders put forward the reverse argument: that the generation thresholdshould be aligned with the 5TWh supply threshold.

3.21. Having considered these competing views, we have decided against changing these thresholds. Our rationale for maintaining the existing rule is:

- **Generation threshold:** The SMA rules are intended to help the smallest suppliers in the market. We do not see any significant benefit in increasing the generation threshold.

- **Supply threshold:** While the overall threshold for an Eligible Supplier is 5TWh, S&P licensees' individual obligations extend to only providing 0.5TWh per Eligible Supplier. This provides an incentive for Eligible Suppliers to negotiate multiple trading agreements as they grow and helps to mitigate 'cliff-edge' effects.

4. Market Making obligation: updated design

Chapter Summary

We set out the changes we have made to the design of the Market Making obligation following feedback from our June consultation. These changes include moving from a 50 per cent availability rule to two hour long trading windows. As a result of this change some additional rules have been added to limit the exposure for proposed S&P licensees.

Market Making obligation: rationale

4.1. The Market Making obligation aims to meet our first and second liquidity objectives of the availability of products that support hedging, and the existence of robust reference prices along the curve, by:

- providing regular opportunities to trade for all market participants, enabling them to meet their wholesale market needs and compete more effectively;

- enabling the development of a series of robust prices along the curve, which can inform a range of commercial decisions, including prices offered to customers, investment in new generation and the scheduling of plant maintenance. This will facilitate competition in both the generation and supply markets and will support security of consumers' supplies; and

- encouraging competition between incumbent players in the market (particularly the domestic supply market), by increasing the scope for firms to compete to identify the best hedging strategy in order to provide the best possible price offer to their customers.

4.2. We also expect that market making could lead to increases in traded volumes in the forward market. As bid-offer spreads narrow it is likely to improve the availability of opportunities to trade so that, all other things being equal, we see a substantial increase in traded volumes. However, an increase in traded volumes may not be necessary for this objective to be met. As long as all companies have the opportunity to trade and robust price information is available in the market along the curve, the market will be functioning sufficiently well to support competition.

Key design changes

4.3. Our design for the Market Making obligation remains broadly as set out in our June consultation. Based on discussions with stakeholders, consultation responses and our own further work, we have identified some changes to improve the effectiveness of the intervention and to address some particular risks to proposed S&P licensees. The key changes are discussed in turn below. The full design of the Market Making obligation is set out in chapter 6.

Availability

Trading windows

4.4. Our June 2013 consultation set out an availability requirement for market makers of 50 per cent of trading hours, calculated over the course of each month. We are now changing this to a requirement to market make during two hour-long windows each day.

4.5. Trading windows have a number of advantages:

- They provide **guaranteed opportunities to trade every day**. Some respondents were concerned that the 50 per cent availability rule might still leave certain days without market making.[11] While the number of required hours is reduced in this revised design, this should be outweighed by the greater certainty of availability for market participants.

- **Market depth should be increased** because all market makers would be present in each window.

- The afternoon trading window is scheduled to **align with activity in the gas market** – this should facilitate trading across the two markets (for example by gas-fired generators).

- Concentrated periods of activity could also provide a **focal point** for the further development of trading.

- There are also potential **practical benefits**. It may be easier for firms to demonstrate compliance in windows, rather than having to add up their periods of market making over a month. Windows may also make it easier for us to monitor compliance. We also received some suggestions that operational costs for licensees may be lower with windows.

[11] For example, market makers might have fulfilled their 50 per cent requirement before the end of the month, leaving a period with no market making.

4.6. As a consequence of moving to trading windows, it is necessary to include some additional rules, which are outlined below. These are exceptions to the requirement to post prices throughout every window. These rules are intended to provide protection for proposed S&P licensees against specific risks, while still ensuring that S&P delivers regular availability.

Reloading rule

4.7. In the context where a licensee is required to market make throughout a window, it is reasonable to allow a short period for the licensee to replace its prices for a particular product after it carries out a trade. Five minutes should be ample time for this, while still leaving plenty of availability in the rest of the window. A reloading period could also minimise the risk to a licensee of having to execute several trades in very quick succession, eg as a result of algorithmic trading.

Volume cap

4.8. A market maker may incur costs if it develops a large open position. To mitigate this risk, we are including a backstop volume cap. This would allow the licensee to withdraw from market making in a particular product for the rest of a window if it had traded a net volume of 30MW in that product in any window. This volume cap is not meant to be used frequently, as it is intended to address extreme risks.

4.9. The 30MW figure seems appropriate. At a minimum, this would require a S&P licensee to be asked to carry out three trades in the same direction in a particular window.[12] However, our best estimate assumption for the impact assessment is that the licensee would be trading each product roughly once per day. The chances of the cap being used would also depend on the number of trades in a product. This means that the cap might be hit occasionally for Month+1 baseload, but more rarely for other products. It is also worth noting that even if the cap is triggered for a single S&P licensee, there would still be products available during the trading window from other S&P licensees.

4.10. We received suggestions that there should be a cap on the overall volumes traded, for example on an annual basis. We are not making this change, because an overall volume cap would limit the potential gains in liquidity from market making. In particular, it could seriously undermine confidence that products would be available on a regular basis. This would be due to the risk that the cap would be hit before the end of the year.

[12] Assuming three trades of 10MW.

Fast market rule

4.11. By allowing licensees to withdraw from market making in a product that is experiencing extreme volatility, the fast market rule may reduce the risk of making significant losses in such conditions.[13] To avoid harming the effectiveness of market making, it is intended to be used sparingly. Such fast market clauses are used in market making agreements with exchanges. However, an important difference is that exchanges generally use some discretion when deciding when to call a fast market. We would not be in a position to exercise such discretion, and so want the trigger to be mechanistic.

4.12. The trigger needs to be reasonably simple for licensees to understand and apply. Our proposed trigger is based on a four per cent price change between the first trade in a window and any subsequent trade in that window. We suggest that the same trigger value would apply to all products; it therefore needs to be appropriate for the most volatile product (Month+1). We looked at recent data on the largest price changes within half-days. However, recent volatility has been lower than in the past, so the final trigger value corrects for this using historical data. The aim is that this trigger should apply for no more than a couple of per cent of the time for the most volatile product – it would therefore apply even less frequently for other products.

Bid-offer spreads

4.13. We are proposing slightly wider bid-offer spreads for baseload products than those we set out in our final proposals. We have given greater weight to arguments that the market spread[14] (which is what ultimately matters for market participants) should be somewhat narrower than the spread posted by any individual market maker. This is particularly as a result of the move to windows, which will ensure that there will be several firms market making at once, increasing the chance that the market spread will be narrower than the individual spread. The precise values selected reflect an industry proposal, which we have considered in the light of data on current spreads. The spreads proposed remain tighter than those seen in the market at present, although this effect is less marked for the products that are currently most liquid.[15]

4.14. For peak products, we have maintained the same proposed spreads as our final proposals. Given that peak products are currently less liquid, current spreads are somewhat less informative as a benchmark. We therefore have focussed on setting limits for peak spreads that have a reasonable chance of facilitating the development of liquidity in peak products. Setting spreads that were too wide would not achieve this aim.

[13] For example as a result of mispricing.
[14] In other words the spread between the best bid and best offer in the market, which may well come from two different parties.
[15] Month+1 and Season+1.

4.15. We received suggestions that S&P licensees should justify their bid-offer spreads *ex post*. Given that the effectiveness of the market making obligation is driven by the limit on the bid-offer spreads, we do not believe that this proposal is acceptable. In particular, by removing the clarity of specified spreads, this would limit the certainty for other market participants about the level of liquidity at any point in time. It would reduce the availability of products and the price robustness generated by market making. We also do not consider that this rule would be workable, as it could lead to protracted enforcement processes.

Transition period

4.16. We received suggestions that it would be preferable to bring in the market making obligation in stages. We are persuaded that there is merit in having a short transition period to help S&P licensees to adapt to the requirements. (This may help to reduce differential impacts on licensees who have less experience of market making in other countries). During this three-month transition period, the maximum permitted spread would be increased by 0.2 percentage points for each product. These slightly wider spreads would provide an increased margin of tolerance for pricing decisions.

4.17. We still want to see benefits for liquidity in the market during the transition period. We therefore consider that it is particularly important that the full product range is included from the start, as this will include the longer-dated and peak products where liquidity is most limited.

Platform rule

4.18. Our June 2013 consultation included a requirement that an eligible platform needed ten generation or supply licensees trading on that platform. We received feedback that this rule could have several undesirable consequences. In particular, respondents argued that this could amount to a barrier to entry for new trading platforms. It was also suggested that compliance with this rule could be difficult – for example, broker platforms do not publish member lists, so a market maker would not know how many other licensees were trading on a particular platform.

4.19. We have therefore moved away from a prescriptive test based on the number of licensees. In general, we want to give licensees flexibility about where to market make, so as to avoid distorting the market for trading platforms. The reason for including a platform rule is to prevent licensees from market making on platforms which (due to their location, rules, fees or any other factors) are likely to severely hinder access to the market making activity, and hence to reduce significantly the effectiveness of the intervention. The platform rule should therefore be seen as an anti-avoidance measure.

4.20. Our policy intention is that small independent generators and suppliers should be able to access products offered by market makers. We expect S&P licensees to market make on platforms which are accessible. If we see S&P licensees choosing platforms with very limited accessability we will consider changes to the licence condition to introduce more prescriptive rules about where the licensees can carry out their market making activity.

Review clause

4.21. Developments in European financial legislation are still ongoing. The revised text of the Markets in Financial Instruments Directive (MiFID II) is being negotiated. Even once the text has been agreed, there will be a further process before the revisions take effect. In addition, the clearing obligation under the European Market Infrastructure Regulation (EMIR) has not yet been applied. There is uncertainty about the final shape of European financial legislation and how this could affect S&P.

4.22. At this stage, we are not able to consider the potential interactions between these developments and our liquidity proposals. We therefore intend to carry out a review at an appropriate point in the future.[16] To help us understand the impacts, we would consult with stakeholders. We would focus particularly on whether revisions to European financial legislation had created any disproportionate changes to the costs faced by S&P licensees. We would intend for any review to be carried out reasonably quickly in order to minimise uncertainty for the market. Any action would be taken after the completion of our review, rather than beforehand. We would not suspend the obligation during the review period as this would prejudge the outcome of the review and would have a detrimental impact on liquidity in the interim.

4.23. To provide reassurance to licensees, we have additionally included a review clause in the licence condition. This sets out that where the licensee considers that forthcoming European financial legislation might materially and adversely affect its ability to comply with its Market Making obligations, it may submit a request (with evidence supporting its case) to the Authority to undertake a review.[17] This review clause is in addition to the existing drafting which allows licensees to nominate a third party to deliver their obligation; the third party could already be within the scope of European financial legislation and therefore unaffected by any changes.

Other consultation feedback

Force majeure

4.24. Some proposed S&P licensees asked for the inclusion of a force majeure clause. This would allow them to cease market making when extreme circumstances meant that they were unable to carry out their obligations. We do not consider that a specific force majeure clause is needed. Our enforcement guidelines already allow us

[16] For example, before MiFID II is implemented in GB.
[17] Any decision to undertake a review would remain at the discretion of the Authority.

to consider whether a matter is a priority when deciding whether or not to launch an investigation.[18]

Specifying spreads in pence

4.25. Some stakeholders thought that it would be preferable to specify bid-offer spreads (and the trigger value for fast markets) in pence rather than as percentages. We can see the argument that using pence might have some benefits in terms of simplicity. However, given that these values will be written in a licence condition, it is important that they can adapt to reflect future market conditions (eg higher or lower power prices). Percentage spreads are better able to do this.

Clip size

4.26. We received several suggestions that the minimum clip size for market making should be reduced. We are not proposing to make this change, as clip sizes down to 0.5MW will be available for small suppliers through the SMA rules. As noted in our final proposals, the proposed clip sizes for market making of 5MW and 10MW reflect trade sizes currently seen in the forward market.

[18] For example, consideration of whether the breach is serious can cover the “harm or potential harm to consumers or to competition resulting from the alleged breach”. (Ofgem (2012), ‘Enforcement Guidelines on Complaints and Investigations’, reference 82/12, p19).

5. S&P reporting requirements

Chapter Summary

We explain how we have taken account of feedback in relation to reporting requirements and set out our updated design.

Rationale for reporting requirements

5.1. To ensure compliance with the licence condition, licensees will have to send us regular reports. We will use the data provided to help us assess progress against our three liquidity objectives. We anticipate publishing an annual liquidity update, and from time to time we may publish high-level data to update the market on the progress of S&P.

5.2. In our June 2013 consultation we suggested that S&P licensees would have to submit high-level quarterly updates and a more detailed annual report. Since then, we have developed our thinking and concluded that it would be beneficial to have detailed reporting quarterly. This will allow us to monitor compliance and assess the effectiveness of the intervention more thoroughly. In addition to these reports we will regularly seek qualitative feedback from market participants to add to our picture of market conditions and the effectiveness of S&P.

Data we will collect

5.3. S&P licensees will be required to provide evidence on a quarterly basis to demonstrate their compliance with the SMA rules and the Market Making obligation. They will also be required to provide details of their activity in the near-term market to assist us in monitoring performance against our third liquidity objective (an effective near-term market). These reports should be submitted to us no more than 30 days after the end of the financial quarter. Templates for the reports can be found in the appendix of the draft Guidance document, published alongside this document.[19]

Supplier Market Access rules – reporting requirements

5.4. Table 1, below, lists the information licensees must provide to demonstrate compliance with the Supplier Market Access rules. This is largely the same as the requirements for annual reports set out in the June 2013 consultation, with some

[19] Ofgem (2013), Liquidity in the wholesal electricity market (Special Condition AA of the electricity generation licence): Draft Guidance.

additional requirements to ensure that we are monitoring compliance with all aspects of the rules. For example, the licensee will now have to provide a statement, signed off by a Director, confirming whether they have complied with all aspects of the rules. This is to ensure we are monitoring compliance with the rules that do not readily lend themselves to data submission. We will on occasion make information requests to verify these statements; therefore licensees should ensure that they keep evidence to support this.

Table 1: Reporting requirements for the SMA rules

Information to be included in quarterly SMA reports

Information on trading agreements with Eligible Suppliers this quarter:
• List of names of Eligible Suppliers:
    ○ with whom a trading agreement has been signed
    ○ with whom negotiations are under way
    ○ who have withdrawn from negotiations
 	
• List of names of Eligible Suppliers with whom the licensee has been unable to offer a trading agreement, and the reasons for the rejection.
 	
Information on trading activities with Eligible Suppliers this quarter:
• Names of Eligible Suppliers with whom the licensee has traded
• Total aggregate volume of each product bought and sold
• Total aggregate number of trades in each product
 	
A statement, signed-off by a Director, confirming:
• the licensee has complied with all the requirements in Schedule A; or
• if the licensee has not complied, giving details of such failure to comply.
 	
Ofgem will from time to time make Information Requests to verify these statements. It is the licensee's responsibility to ensure that it has evidence to demonstrate compliance with these rules. Credit Transparency Forms do not need to be submitted as part of the quarterly reporting but should be submitted if requested.
 	
This evidence, and the Credit Transparency Forms, should be kept for three years and be provided to Ofgem within five working days of Ofgem requesting it.
 	
Other information:
• A link to where contact details and the list of information required from Eligible Suppliers is hosted on the licensee's website
• A statement that the information is up to date

Market Making obligation – reporting requirements

5.5. Table 2, below, lists the information licensees must provide to demonstrate compliance with the Market Making rules. The information we are asking for differs somewhat from the reporting requirement set out in our June 2013 consultation. This is largely because the move from the 50 per cent availability rule to trading windows should make it easier for licensees to confidently confirm meeting the availability criteria on their own, removing the need for them to ask platforms to provide reports for them. As with the SMA reporting requirements, we will on occasion make information requests to verify statements of compliance, therefore licensees should ensure that they keep evidence to support this.

Table 2: Reporting requirements for the market making obligation

Information to be included in quarterly market making reports
Information on trading activities as a market maker this quarter: • Gross volume traded in each product, for each month in the quarter • Number of trades in each product, for each month in the quarter **A statement, signed-off by a Director, confirming that this quarter** • the licensee complied with all the requirements of Schedule B; or • if the licensee has not complied, giving details of such failure to comply. *Ofgem will from time to time make Information Requests to verify these statements. It is the licensee's responsibility to ensure that it has evidence to demonstrate compliance with these rules. This information should include:* • *Time-stamped bid and offer data* • *Time-stamped trade data (indicating whether a trade was a buy or sell)* • *The platform that market making was conducted on.* *We may verify information provided by licensees against information provided by platforms. A platform is only eligible as a platform for meeting the market making obligation if it meets the requirements of paragraph 5 of Schedule B including the obligation to provide such information when requested by Ofgem.* *This evidence should be kept for three years and be provided to Ofgem within five working days of Ofgem requesting it.* **Evidence to support occasions where a constant presence was not maintained during a trading window:** • Due to a fast market • Due to the volume cap **Other information:** • Names of platforms licensee has used to market make • Name of Nominee (if used) • Number of market participants Nominee is set up to trade with (if used)

Near-term market – reporting requirements

5.6. As noted in our June 2013 consultation, our final S&P proposals do not feature intervention in the near-term markets. The near-term markets are functioning well and it is not clear that there is a rationale for intervention in them at this stage.

5.7. However, we will continue to monitor near-term markets closely to track progress. If we believe that near-term liquidity is deteriorating and that intervention would be beneficial then we will be prepared to act. To improve the quality of our monitoring we have included a requirement to report the volumes traded through day-ahead auction platforms.

How we will use the data submitted

5.8. Some of the data we collect from licensees will be a useful indicator of the success of S&P and used to assess progress against our three liquidity objectives. Table 3 below highlights how the data may be used:

Table 3: Use of data

Data collected	Indicates
• Names of Eligible Suppliers with whom a trading agreement has been signed • Volume traded under the SMA rules • Number of trades conducted under the SMA rules • Volume traded in each product through the SMA rules	• Accessibility of the market to small suppliers • Extent to which small suppliers are making use of the SMA rules
• Volume traded in each product through the market making obligation	• Accessibility of products which support hedging • Robustness of prices along the curve
• Volumes bought and sold through day-ahead auctions	• Effectiveness of near-term markets

5.9. We will use this data alongside our existing market monitoring activities and qualitative feedback from market participants to build up a comprehensive picture of the progress of the wholesale market against our liquidity objectives.

5.10. This data will also feed into an assessment of liquidity in the wholesale market, which we will publish annually. Confidential data would be anonymised and would be used purely to demonstrate the overall performance of the market and the effectiveness of S&P rather than to demonstrate the performance of any individual licensee. From time to time we may also publish high-level data – for example to demonstrate improvements in the market as a result of S&P.

6. Our final policy design

Chapter Summary

We summarises our final policy design. We ask for respondents' views on whether our proposed licence modifications reflect our policy proposals.

Question 1: Do you consider that the proposed licence modifications appropriately reflect the policy proposals as described in this chapter?

Policy aim

6.1. To provide a framework for our liquidity work, we have set out three liquidity objectives for the GB wholesale electricity market. These reflect the features we would expect from a well-functioning, liquid market that delivers for consumers. These objectives are:

- **Objective 1: Availability of products to support hedging –** Our first liquidity objective is the availability of wholesale electricity products that firms require to allow them to enter the market and compete effectively. During the project we have been particularly concerned about longer-dated and peak products, as these have particularly limited liquidity at present. We are also interested in whether products can be accessed by a range of market participants, including entrants and smaller players.

- **Objective 2: Robust reference prices along the curve –** Our second liquidity objective looks at forward prices. It reflects the need for liquidity to support prices along the forward curve that are trusted to provide a fair reflection of the value of products. These prices provide valuable signals for market participants that inform their commercial decision making and enable them to compete.

- **Objective 3: An effective near-term market –** Our third liquidity objective relates to the period closer to delivery (for example, within the week before delivery). Liquidity in this period is important as it allows firms to match their contracted positions to their physical volumes and avoid imbalance charges. A robust near-term price might also underpin the development of greater liquidity along the curve by acting as a reference price for the settlement of financial futures. Near-term liquidity may be affected by a range of particular factors, such as plant outages and weather forecasts.

6.2. The market has not made sufficient progress against our first two objectives and we remain concerned about the overall level of liquidity, particularly along the curve. We also remain concerned about the accessibility of the market for small suppliers.

Intended effect of our "Secure and Promote" policy design

6.3. 'Secure and Promote' aims to address these concerns and improve the liquidity of the wholesale power market. It is intended to secure existing positive developments in the market, specifically the progress made by some of the large vertically integrated companies to improve their approach to trading with smaller counterparties. It also intends to promote further progress where necessary. To do this, we will introduce three mechanisms:

- **The Supplier Market Access rules:** these rules will improve accessibility of the wholesale market for small market participants by establishing a framework through which small suppliers can seek agreements to trade with obligated generators;

- **The Market Making obligation:** this obligation will ensure that all market participants will have opportunities to trade every day in a range of peak and baseload products along the curve. It will also ensure that prices are visible and are representative of the value that the market places on each product; and

- **Reporting requirements:** to ensure compliance with the licence condition licensees will have to submit regular reports to Ofgem. We will use the data provided to help us assess progress against our liquidity objectives, including our third objective of an effective near-term market.

6.4. We expect that when 'Secure and Promote' takes effect prices should be immediately evident along the curve. It is intended to also rapidly improve conditions for existing independent firms in the market. Over time we would also expect it to contribute to making conditions more favourable for new entrants to the market.

Policy Design

6.5. We summarise our final policy design through the tables below.

Supplier Market Access rules

6.6. The Supplier Market Access rules are reflected in Schedule A of the licence condition. The final design is set out in Table 4 below.

Table 4: Supplier Market Access Rules

Area	Supplier Market Access rules
A1 – Transparency	Licensee must provide a **named contact** (or contacts) on its website for requests for trading agreements. Licensee must provide on its website a **list of the information** that is required from a potential counterparty in order to process a request for a trading agreement. Licensees may only request information that is relevant to this request.
A2 – Scope	Licensees must follow these rules in trading with all suppliers whose affiliated parties supplied less than 5TWh and generated less than 1TWh in the previous year, up to a limit of 0.5TWh per counterparty. Ofgem will publish a list of eligible suppliers. If a group has multiple generation and/or supply licences, eligibility will be considered on a group basis.
A3 – Response to trading requests	**Requests for trading agreements** Licensees must respond in a timely manner, by fulfilling the steps below: 1. Licensees must **acknowledge receipt of a written request** for a trading agreement within 2 working days. 2. The licensee **must send a written response to the request** within 20 working days after receipt of a trading request. Time spent waiting for additional information from its counterparty will not be counted against the 20 working days. 3. The written response must include: a formal offer of a trading agreement including all relevant terms and conditions; or legitimate reasons why the licensee cannot trade with the counterparty. 4. Licensee must ensure that any subsequent **negotiations** proceed in a timely manner. The licensee will not be held responsible for delays due to its counterparty. 5. If no agreement has been reached within 40 working days from the date of the licensees written response, the licensee must write to the counterparty within 5 working days, noting the outstanding areas of disagreement, and **offering a meeting** within 20 working days to discuss these areas. 6. Following the meeting, if no agreement is reached, the licensee must continue to negotiate in good faith until such time as an agreement is reached or both parties agree to cease discussions. 7. Small suppliers are expected to negotiate in good faith. Ofgem reserves the right to remove them from the list of eligible suppliers in the event that they act in bad faith eg through vexatious requests for a trading agreement.

<table>
<tr><td></td><td>Requests to trade
Once a trading agreement is in place, the licensee must respond to requests to trade within 3 hours of receipt. If the request is received on a non-working day, or less than three hours before the end of a working day, a response must be provided by 11.00 am on the next working day.</td></tr>
<tr><td>A4 – Credit and Collateral</td><td>Licensees must offer proportionate credit and collateral arrangements.
These will be considered to be proportionate when the following conditions are met:
In reaching its decision the licensee has followed a established process, assessing the individual circumstances of the counterparty through consideration of a range of relevant information
The licensee has considered, and where appropriate, discussed with the counterparty a range of appropriate credit support options
The credit terms offered are clearly linked to the assessment carried out
When responding to a request for a trading agreement, the licensee must complete a Credit Transparency Form which justifies its credit decision. The licensee must share the Credit Transparency From with the counterparty and be prepared to discuss it.
These credit forms should be held on file for Ofgem audit for three years.</td></tr>
<tr><td>A5 – Clip Size</td><td>If requested, licensee must trade clip sizes as small as 0.5MW, and in minimum increments of 0.5MW above that. The maximum clip size the licensee will be obligated to trade is 10MW.</td></tr>
<tr><td>A6 – Product Range</td><td>If requested, the licensee must be willing to trade at least the following standard products:
Baseload: Week+1, Month+1, Month+2, Quarter+1, Season+1, Season+2, Season+3, Season+4
Peak: Week+1, Month+1, Month+2, Quarter+1, Season+1, Season+2, Season+3</td></tr>
<tr><td>A7 – Fair and Transparent Pricing</td><td>The licensee must provide a quote which is as good as the best price that is available to them in the market for the relevant product.
The licensee may add and where added, must itemise separately:
an objectively justifiable risk premium for trading in small</td></tr>
</table>

	clip sizes. • any **fees** incurred from procuring the product externally (for example, trading fees) The licensee may not add: • any administration or service charge, or any other internal cost (eg staff cost) incurred when trading with the eligible supplier.

Market Making obligation

6.7. The Market Making obligation is reflected in Schedule B of the licence condition. The key elements of the final design are set out in Table 5 below.

Table 5: Market Making obligation

Area	**Market making – policy design**
Platform	The platform(s) used for market making must meet the following criteria: • **Products –** It must be possible to trade at least one of the products on the platform • **Independence** – The platform must be operationally independent from the licensee • **Activity –** The licensee must have a reasonable expectation that the products will be traded on the platform • **Information provision** – The platform must be prepared to provide trading data to Ofgem when requested for the purpose of monitoring compliance
Products	The licensee must post bids and offer prices in the following products: **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.
Trade size	At any particular posted bid or offer price, the licensee must be willing to trade in clip sizes of 5MW. The **maximum trade size the licensee must execute is 10MW**, although they may trade larger volumes if they wish. If a third party is nominated to meet the obligation of two licensees, the maximum trade size multiplies accordingly.
Availability: Main rule	The licensee must market make for **two hour-long windows each day**. These windows will start at 10.30am and 3.30pm.

<table>
<tr><td>Availability: Reloading</td><td>The licensee must replace its bid-offer for a product no more than five minutes after trading that product.</td></tr>
<tr><td>Availability: Volume cap</td><td>For a particular product, if a licensee trades a net volume of 30MW in a particular direction in a single window, it may cease posting a bid-offer spread for that particular product for the remainder of that window.

Trade sizes that exceed the maximum clip size that the licensee is obliged to trade (usually 10 MW), will not count towards this volume cap.</td></tr>
<tr><td>Availability: Fast market rule</td><td>A fast market is determined by reference to the price change between the first trade in a trading window and any subsequent trade in that window.

For the purposes of this licence condition, the price change that triggers a fast market is 4%. The same value applies to each product.

For this calculation, a trade can take place on any platform that is an eligible platform for market making.

If a fast market is triggered in one product, it applies to that product only.

For products in a fast market, the obligation to quote a bid-offer spread is lifted. The fast market applies for the remainder of the trading window. The obligation resumes as usual at the start of the next trading window.

It is the responsibility of the licensee to determine whether a fast market is occurring. If the licensee calculates that there is a fast market, and chooses to withdraw its bid-offer spread, it must:
i. Document the circumstances so that this can be explained in case of audit.
ii. Note all usage of the fast market rule in its quarterly reports to Ofgem.</td></tr>
<tr><td>Bid-offer spreads</td><td>When market making, the licensee must maintain a spread between their bid and offer price narrower than:
<table>
<tr><th colspan="2">Baseload</th><th colspan="2">Peak</th></tr>
<tr><td>Month+1
Month+2
Quarter+1
Season+1
Season+2</td><td>0.5%</td><td>Month+1
Month+2
Quarter+1
Season+1
Season+2</td><td>0.7%</td></tr>
<tr><td>Season+3
Season+4</td><td>0.6%</td><td>Season+3</td><td>1%</td></tr>
</table></td></tr>
<tr><td>Transition period</td><td>For the first three months after the licence condition comes into force, maximum permitted bid-offer spreads are increased by 0.2 percentage points for all products.</td></tr>
</table>

Obligation to trade	Providing normal prerequisites are in place (eg a GTMA and credit agreement), if requested, the licensee **must trade** at posted prices.
Nominating a third party	**Licensee may nominate a third party** to undertake their obligation on the same basis set out in this licence condition (unless otherwise specified). The licensee must not nominate any party delivering more than one other licensee's obligation.
	The third party must have arrangements in place to trade the products with at least five market participants.
MiFID reopener	Once there is more clarity about European financial legislation, we intend to review the licence condition to check that it remains appropriate.

Reporting requirements

6.8. The reporting requirements are reflected in Schedule C of the licence condition. The final design is set out in Table 6 below.

Table 6: Reporting requirements

	Element	**Requirements**
Schedule A	Information on trading agreements with Eligible Suppliers for each quarter	Names of Eligible Suppliers: ○ with whom a trading agreement has been signed ○ with whom negotiations are under way ○ who have withdrawn from negotiations ○ with whom the licensee has been unable to offer a trading agreement, and the reasons for the rejection
	Information on trading activities with Eligible Suppliers for each quarter	• Names of Eligible Suppliers with whom the licensee has traded • Total aggregate volume of each product bought and sold • Total aggregate number of trades in each product
	A statement, signed-off by a Director:	• Either confirming that the licensee has complied with all the requirements in Schedule A; or • If the licensee has not complied giving details of such failure to comply
	Other information	• A link to where contact details and the list of information required from Eligible Suppliers is hosted on website • A statement that the information is up to date

Schedule B	Information on trading activities as a market maker for each quarter	• Gross volume traded in each product, for each month in the quarter • Number of trades in each product, for each month in the quarter
	A statement, signed-off by a Director, confirming:	• Either that the licensee complied with all the requirements of Schedule B; or • If the licensee has not complied, giving details of such failure to comply
	Evidence to support occasions where a constant presence was not maintained during a trading window	• Due to a fast market • Due to the volume cap
	Other information	• Names of platforms licensee has used to market make • Name of Nominee (if used) • Number of market participants Nominee is set up to trade with (if used)
Schedule C	Information on activity in the near-term market	• Gross volumes bought and sold through day-ahead auctions each month

Statutory consultation

6.9. The attached schedule to the section 11A(2) Electricity Act 1989 notice sets out draft licence text that is intended to reflect the our final policy design, as summarised in this chapter.

- Do you agree that the draft licence text in the Schedule attached to the section 11A(2) notice reflects our final policy position?

Appendices

Index

Appendix 1 – Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from obligated parties.

1.2. We would especially welcome responses to the specific question set out in chapter 6 and replicated below.

1.3. Responses should be received by 19 December and should be sent to:

Graham Knowles
Wholesale Market Performance
Ofgem, 9 Millbank, London, SW1P 3GE
020 7901 7103
gb.markets@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Any questions on this document should, in the first instance, be directed to Graham Knowles.

CHAPTER: Six

Question 1: Do you consider that the proposed licence modifications appropriately reflect the policy proposals as described in this chapter?

Appendix 2 – Notice under Section 11A(2) of the Electricity Act 1989

Please see separate document published alongside this statutory consultation.

Appendix 3 – Glossary

A

Agency for the Cooperation of Energy Regulators (ACER)

ACER is a European Union body which cooperates with EU institutions and stakeholders, notably National Regulatory Authorities (NRAs) and European Networks of Transmission System Operators (ENTSOs), to deliver a series of instruments for the completion of a single energy market.

APX

APX owns and operates energy exchange markets in the Netherlands, UK and Belgium. APX provides a power spot exchange service in the UK.

B

Barrier to entry

A factor that may restrict entry into a market.

Baseload product

A product which provides for the delivery of a flat rate of electricity in each hourly period over the period of the contract.

Bid-offer spread

The bid-offer spread shows the difference between the price quoted for an immediate sale (offer) and an immediate purchase (bid) of the same product; it is often used as a measure of liquidity.

Broker

A broker handles and intermediates between orders to buy and sell. For this service, a commission is charged which, depending upon the broker and the size of the transaction, may or may not be negotiated.

C

Carbon Price Floor

A minimum price for carbon released during electricity generation in the UK. The Carbon Price Floor will come into effect from 2013.

Churn rate

Churn is typically measured as the volume traded as a multiple of the underlying consumption or production level of a commodity.

Clearing

The process by which a central organisation acts as an intermediary and assumes the role of a buyer and seller for transactions in order to reconcile orders between transacting parties.

Clip size

The size (usually in MW) of the contract to be traded.

Collateral

A borrower will pledge collateral (securities, cash etc) in order to demonstrate their ability to meet their obligations to repay monies loaned. The collateral serves as protection for a lender against a borrower's risk of default.

Contract for Difference (CfD)

A contract where the payoff is defined as the difference between a pre-agreed ‘strike’ price and a reference price (determined in relation to an underlying commodity). The Government has proposed the use of CfDs as part of Electricity Market Reform. CfDs under EMR are intended to encourage investment in low-carbon generation by providing greater long-term revenue certainty to investors.

D

Day-ahead market

A form of near-term market where products are traded for delivery in the following day.

Department of Energy and Climate Change (DECC)

The UK Government department responsible for energy and climate change policy.

E

Electricity Market Reform (EMR)

EMR is the Government’s approach to reforming the electricity system to ensure the UK’s future electricity supply is secure, low-carbon and affordable.

European Target Model

The European Target Model sets out the vision for a single European market in electricity by 2014. The objective of the Target Model is to remove barriers to cross-border trade and encourage harmonisation of European wholesale market arrangements. This is to be achieved through the development of European wide, legally-binding, network codes. As a National Regulatory Agency, Ofgem has a role in implementing the Target Model.

Exchange

A type of platform on which power products are sold. Typically an exchange would allow qualifying members to trade anonymously with other parties and the risks between parties would be managed by a clearing service.

F

Financial Product

A contract that is settled financially at maturity rather than by the delivery of a physical commodity.

Forward Curve

A series of sequential time segments within which it is possible to trade a particular commodity and for which prices are available.

Forward trading

The trading of commodities to be delivered at a future date. Forward products may be physically settled – by delivery – or financially settled.

G

Grid Trade Master Agreement

A Grid Trade Master Agreement (GTMA) is a legal agreement between the two parties in a trade that sets out terms in relation to financially settling the contract and physically delivering the power.

H

Hedging

Transactions which fix the future price of a good or service, and thereby remove exposure to the daily (or spot) price of a good or service. This enables those purchasing a good or service to reduce the risk of short term price movements.

I

ICE

Intercontinental Exchange, an American financial company that operates Internet-based marketplaces which trade futures and over-the-counter (OTC) energy and commodity contracts as well as derivative financial products.

IFA

The electricity interconnector between GB and France.

Imbalance

The difference between a party's contracted position and metered position measured on a half-hourly basis.

M

Market Coupling

Market coupling is a method for integrating electricity markets in different areas, applied across a number of European countries.

Market Making

A firm which is regularly prepared to buy and sell in a commodities or financial market. Market makings post two-sided (bid and ask) prices on a regular basis, encouraging greater liquidity.

N

N2EX

The N2 Exchange, a GB electricity market platform, is operated by Nasdaq OMX and Nord Pool Spot AS.

Near-term market

The market in which the products are traded close to delivery (for example, on the day of delivery or day-ahead of delivery.

Nord Pool

Nord Pool, the Nordic Power Exchange, a single power market for Norway, Denmark, Sweden and Finland.

O

Off-peak product

A product which provides for the delivery of a flat rate of electricity for the period of the day when demand is typically lowest for the duration of the contract.

Over the Counter (OTC)

Trading of financial instruments, including commodities, that takes place directly between counterparties. This is in contrast to exchange-based trading where the exchange acts as a counterparty to all trades.

P

Peak product

A product which provides for the delivery of a flat rate of electricity for the period of the day when demand is typically highest for the duration of the contract.

Physical settlement

A contract that, at maturity, results in an exchange of the contracted good for its contracted value.

Product

The type of contract available. Examples include day-ahead, weekly, weekend, block seasonal, year, etc. Standard products are those that are widely traded on well-established terms, so exchanges generally deal in standard products. By contrast, structured products are those where the terms are precisely tailored to match the contract buyer’s requirements, and they usually involve variable contract volumes and/or non-standard volumes and durations.

R

Reference price

A price for a product which has been revealed through enough trading for it to be considered reflective of the product’s ‘true’ market value.

Retail Market Review (RMR)

Ofgem’s Retail Market Review aims to make the energy market simpler, clearer and fairer for consumers, encouraging and equipping them to engage effectively so that they can get the best deal.

S

Shaped product

A shaped product is a contract which specifies different amounts of electricity to be delivered at different times. A bespoke shaped product with half-hour granularity could specify a different volume for every half-hour period of the contract’s duration.

Spot market

Refers to the market in which products traded are delivered at (or close to) delivery.

T

Third Package

The Third Package is EU legislation on European electricity and gas markets that entered into force on the 3rd September 2009. The purpose of the Third Package is to further liberalise European energy markets. DECC is primarily responsible for its transposition in Great Britain and had to do this by 3rd March 2011.

V

Vertical Integration

Where one corporate group owns two or more parts of the energy supply chain. For example, where the same group features both generation and supply businesses.

Appendix 4 – Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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