SCOTTISHPOWER

Rupert Steele OBE
Director of Regulation

Graham Knowles
Wholesale Market Performance
Ofgem
9 Millbank
LONDON
SW1P 3GE

18 December 2013

Dear Graham,

WHOLESALE POWER MARKET LIQUIDITY: STATUTORY CONSULTATION ON THE 'SECURE AND PROMOTE' LICENCE CONDITION

We are pleased to respond to Ofgem's statutory consultation on the 'Secure and Promote' licence condition, and on the associated impact assessment and draft guidance. Our comments on these are provided in Annexes 1, 2 and 3 respectively.

<u>Cost and proportionality</u>

We welcome the changes that Ofgem has made to the proposed market making obligation in response to its previous consultation, in particular the relaxation of platform criteria, the 'MiFID reopener', the maximum position limit, 5 minute reload times, fast market rules and increased bid-offer limits. These have addressed some of the problems we previously identified.

However, we remain concerned that the costs and risks of mandatory market making are very difficult to predict, particularly as we enter an era of growing price volatility. As explained in Annex 2, we believe there is a real possibility that the costs for obligated parties could turn out to be significantly greater than estimated by Ofgem. We think two steps should be taken to mitigate this.

- First, where possible, the obligations on obligated parties should be made proportionate to the parties' market shares. Instead of a uniform net volume cap of 30MW, we think the cap should vary (in increments of 5 or 10MW) in proportion to market share; and rather than being required to post bids and offers in 5MW and 10MW clip sizes, smaller companies should be obligated only to post 5MW clip sizes (with the option to post larger sizes if they wish). These two measures would help reduce the risk of competitive distortion.

- Second, Ofgem should make allowance in its guidance for a 'reopener' where there is evidence that the costs and risks incurred by obligated parties have changed significantly (either as a result of under-estimates in the original impact assessment or changing market conditions). If a licensee is able to demonstrate that it is facing disproportionate costs and risks in continuing to meet the licence condition, it should be able to apply to Ofgem to have that obligation modified or removed. In extreme cases (and where supported by appropriate evidence), it should also be able to apply for immediate suspension of the obligation pending Ofgem's decision.

ScottishPower London Office, 4th Floor, 1 Tudor Street, London EC4Y 0AH
Telephone +44 (0)141 614 2000, Fax +44 (0)141 614 2001, Direct +44 (0)141 614 2012
rupert.steele@scottishpower.com www.scottishpower.com

Licence condition drafting

We agree that the proposed licence modifications broadly reflect the policy proposals set out by Ofgem. We have identified in Annex 1 one apparent exception: the volume cap in the market making obligation. The policy proposal is that the cap applies when the net position *reaches* 30MW whereas the licence condition says that it applies when the position *exceeds* 30MW. We assume that this is a drafting error and suggest that the licence condition is corrected (and the guidance which quotes the licence condition). We have also noted the need to momentarily delete the posting when changing prices and are seeking clarity that the obligation to post prices "at all times" allows for this.

Timescale for introduction

Ofgem says that (subject to the consultation), it intends the licence modifications for obligated parties to be implemented on 31 March 2014. We believe this date is too early and that Ofgem has underestimated the preparatory activity that obligated parties will need to carry out to ensure sufficiently robust systems for market making – particularly for parties who do not currently market make. It is essential that IT systems are fully tested before going live, that trading procedures have been developed and that staff have had adequate training. If any of the IT systems of obligated licensees or any of the platforms providing market making services is not fully operational from the outset, this could expose obligated parties to significant financial risk. We therefore believe it would be prudent to delay implementation until 1 July 2014.

We also believe it would be prudent to phase implementation of the baseload and peak products included in the market making obligation, concentrating on the shorter dated products in the initial phase with longer dated products implemented later.

Guidance document

In relation to the market making obligation the draft guidance document identifies generation market share and domestic supply market share as key factors in deciding whether or not a licensee should be subject to the obligation. In the interests of regulatory certainty we think Ofgem should include in the guidance the level of generation market share and the level of domestic supply market share below which a licensee would not be obligated to market make. This would make it easier for both obligated and potentially obligated licensees to understand the implications of significant changes in the size of their generation and domestic supply businesses and would ensure compliance with Directive 2009/72/EC. We are not aware of any competitive market where participants with a market share of less than 10% are obligated to market make with regulated bid-offer spreads.

As noted above, we think the guidance should also make it clear that if any licensee who is subject to the market making obligation is able to demonstrate to Ofgem that it is facing disproportionate costs and risks in continuing to meet the licence condition then the obligation will be modified or removed.

I hope that you will find these comments useful. Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,

Rupert Steele

Rupert Steele
Director of Regulation

Annex 1

WHOLESALE POWER MARKET LIQUIDITY: STATUTORY CONSULTATION ON THE 'SECURE AND PROMOTE' LICENCE CONDITION

SCOTTISHPOWER RESPONSE

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

We have identified one area where the proposed licence modifications do not appropriately reflect the policy proposals set out in chapter 6 of the statutory consultation.

Paragraph 10 of Schedule B to the licence condition, which provides for a volume cap in the market making obligation, is inconsistent with the final policy design set out in the statutory consultation. The final policy design states that when the net volume reaches 30MW the licensee may cease posting a bid-offer spread for that particular product[1] whereas the licence condition (and guidance) state that when the net volume exceeds 30MW the licensee may decide to cease posting bids and offers for that product. If trades are in 10MW clip sizes then the wording in the licence condition could result in the cap only taking effect when the net volume reaches 40MW.

The licence condition and guidance wording should therefore be changed to:

> *If at any time in a trading window the difference between the licensee's traded bid volume and traded offer volume in respect of a Product* ***is 30MW or greater****, the licensee may decide to cease posting bids and offers for that Product for the remainder of that trading window.*

There is a second drafting point on which we would appreciate clarification. Paragraph 6(a) of Schedule B to the licence condition requires that:

> *Bids and offers for each Product must be posted on a qualifying platform at all times (subject to paragraph (b)) in the periods of 60 minutes (each a "trading window") starting respectively at 10.30 hours and 15.30 hours every working day.*

When changing prices, it is generally necessary to delete the old bid-offer price pair on a trading platform momentarily before posting the new price pair. The delay will depend on the platform software but will be less than 5 seconds. We assume that such momentary interruptions would not be considered to contravene the requirement to post prices 'at all times', but we would appreciate confirmation of this and if necessary adjustment of the condition wording.

[1] Statutory consultation paragraph 4.8 and paragraph 6.7, Table 5

<u>Annex 2</u>

WHOLESALE POWER MARKET LIQUIDITY: STATUTORY CONSULTATION ON THE 'SECURE AND PROMOTE' LICENCE CONDITION – IMPACT ASSESSMENT

SCOTTISHPOWER RESPONSE

Question 1: Do you agree with our description of the key issues and objectives for our Secure and Promote proposals?

<u>Importance of liquidity</u>

We agree that liquidity in the wholesale electricity market is important to ensure that all firms in the market can buy and sell electricity products when they want, to allow generators and suppliers to obtain a range of products to manage their risks and to provide robust prices and price signals to inform trading decisions, hedging strategies, tariff offers, decisions about when to sell output and operational decisions for generators.

<u>Ofgem's liquidity objectives</u>

We agree that availability of products that support hedging, robust reference prices along the curve and an effective near-term market are key objectives for ensuring that the GB wholesale power market supports competitive supply and generation markets through reliable trading in key products and provision of robust signals.

<u>Updated liquidity metrics</u>

We note that Ofgem's update on the metrics used to measure liquidity shows that churn, at around 3, has remained flat in 2013 and bid-offer spreads have tightened along the curve for both baseload and peak products during the first three quarters of 2013. We do not believe that overall churn rates are having an adverse impact on the market for baseload products but we do accept that there are likely to be benefits from increasing liquidity in the market for peak products.

Question 2: Do you agree with our evaluation of the impact of our Secure and Promote proposals on consumers?

<u>Competitive pressure on consumers' bills</u>

We agree that increased liquidity could improve the efficiency of wholesale markets by allowing generators to compete more effectively. However it is unclear to us that prices in the electricity wholesale market are currently above the efficient level – indeed many observers think that current wholesale power prices are well below new entry costs, leading to the need for capacity interventions. It is therefore unclear to us whether additional liquidity will create a downward, rather than an upward, pressure on wholesale prices. In any event, if generators are required to fund the costs of liquidity measures then this will create upward pressure on wholesale prices. Overall the net impact on wholesale prices seems uncertain. We agree that increased availability of longer-dated products should enable suppliers to protect their customers from short-term increases in wholesale prices and could help them to compete more actively on the price they offer to consumers.

We agree that competition between suppliers incentivises them to become more efficient, leading to reductions in operational costs. However, we think that the positive impact on supply competition resulting from facilitating new entry may be offset by the adverse impact resulting from distortion of competition between larger obligated suppliers. Under the current proposals each obligated supplier faces an identical obligation, so the cost per customer for smaller obligated suppliers will be several times the cost per customer for the largest. This will increase the profit margins of larger obligated suppliers and reduce the profit margins of smaller - a distortion of competition which is likely to be adverse to consumer interests. This is why we believe the obligation should be designed so that its cost is proportionate to the obligated parties' relevant market share.

Choice and innovation

We agree that firms operating in a competitive market face increased incentives to be responsive to their customers and to innovate. So if the secure and promote measures lead to increased competitive pressure from smaller suppliers, this may lead to improved choice, service quality and innovation.

Costs

In relation to the costs faced by obligated licensees, although Ofgem has increased its estimate of these costs, we believe they are still significantly under-estimated, in particular the ongoing costs associated with market making (see our response to Question 5 below). Larger benefits would thus be required to ensure that consumers' bills were not higher as a result and in our view Ofgem has still not made the case that sufficient benefits would materialise.

Question 3: Do you agree with our evaluation of the impact of our Secure and Promote proposals on competition?

Supplier Market Access rules

We agree that the Supplier Market Access rules will facilitate entry and competition by smaller suppliers by addressing directly the specific issues faced by these firms. They build on voluntary commitments we have made to all independent suppliers for the last three years enabling them to secure bilateral credit lines and be able to access the wholesale market in the trade sizes, duration and shapes required to operate their businesses. Formalising these commitments into rules should further improve competition for smaller suppliers by ensuring that other major players take similar actions.

Market making obligation

The market making obligation is intended to complement the Supplier Market Access rules for independent suppliers through assisting new entrants in gaining access to the products they need. It is likely to be of less direct utility to obligated licensees. As noted by Ofgem, market spreads are continuing to tighten and directly deliver a clearer view of the price.

While market making is a feature of some power markets in Europe and is also used beyond power markets, the design of Ofgem's market obligation has not to our knowledge been tried and tested in any market comparable to the GB market. We are not aware of any competitive market where participants with a market share of less than 10% are obligated to market make with regulated bid-offer spreads.

Competition between platforms

We welcome Ofgem's decision not to mandate the use of a particular platform for market making. We agree that it is more appropriate for market participants to select the platforms that best meet their needs and that there are benefits from competition between trading platforms.

Impact on obligated licensees

Ofgem has recognised that licensees obligated to market make will incur costs which their competitors will avoid and that this could affect competition. Ofgem expects these costs to be small relative to the size of obligated licensees' businesses and thus for the impact to be small. We believe the costs could be significantly greater than Ofgem's estimates (see Question 5 below) and thus relative competitiveness could be impacted.

Ofgem has also recognised that the design of the market making obligation is likely to result in each of the six obligated firms trading a similar amount and thus incurring similar costs. Given the different size of these firms Ofgem has estimated that the cost per unit facing the smallest firm would be around double the cost faced by the median-sized firm. Such a differential has the potential to adversely impact competition between obligated licensees. If, as we believe, the costs are significantly higher than estimated by Ofgem, this distortion of competition will be material.

Where possible, we think the obligations on obligated parties should be made proportionate to the parties' market shares. This could be achieved in two ways:

- Instead of a uniform net volume cap of 30MW, we think the cap should vary (in increments of 5 or 10MW) in proportion to market share.

- Second, rather than being required to post bids and offers in 5MW and 10MW clip sizes, smaller companies should be obligated only to post 5MW clip sizes (with the option to post larger sizes if they wish).

The above two measures would help reduce the risk of competitive distortion.

Question 4: Do you agree with our evaluation of the impact of our Secure and Promote proposals on sustainable development?

Electricity Market Reform

We recognise the important role market liquidity plays in the transition to a low carbon economy through providing liquid reference prices for the intermittent and baseload generation CfDs being introduced through EMR. Actions taken by us and other major participants on a voluntary basis have already delivered sufficient increased liquidity into the day-ahead market for this to be used for the reference price for intermittent low carbon generation.

We agree that a liquid reference price for the baseload CfD should increase investor confidence in the returns available and encourage investment in baseload low carbon generation. Market making could improve the robustness of forward prices and could help to move the reference price for low carbon baseload generation from season-ahead to year-ahead. In the particular circumstances of the UK market, the use of trading windows for the market making obligation should increase market depth through concentrating trading and could increase the robustness of year-ahead baseload prices.

Question 5: Do you agree with our evaluation of the cost impacts of our Secure and Promote proposals?

Supplier Market Access set-up costs

Our estimate of the set-up costs to provide the services to small independent suppliers set out in the Supplier Market Access rules is within Ofgem's range at the lower end. Costs going forward will of course be dependent on the level of take-up by eligible small suppliers but we believe it would be unlikely for any obligated licensee to incur costs in excess of the upper end of Ofgem's range.

Supplier Market Access ongoing costs

Based on our experience to date, our estimate of the Supplier Market Access ongoing costs is also within Ofgem's range. Credit costs are the most significant element and it must be recognised that the potential cost of default by a counterparty can be a significant risk for those who do not have investment grade ratings or parent company guarantees and thus these costs could exceed Ofgem's high case.

We agree with Ofgem's amendment to the policy design allowing obligated licensees to charge a risk premium for trading in small clip sizes recognising that when a small clip is traded an open position will be created which will need to be combined with other small trades before it can be traded out in the market.

Market making set-up costs

We believe Ofgem has underestimated the set-up costs for market making that will be incurred by obligated licensees, particularly those who currently do not market make. Our estimate is that costs will be in excess of Ofgem's high case estimate of £400,000. We will need to incur significant costs for IT systems and it is essential that these systems are fully tested before going live.

Furthermore, as noted in the covering letter, if any of the IT systems of obligated licensees or any of the platforms providing market making services are not fully operational from the outset, this could expose parties to significant financial risk. We therefore believe it would be prudent to delay implementation until 1 July 2014.

Market making ongoing costs

Ofgem has made changes to the design of the market making obligation which should reduce the potential ongoing costs for obligated licensees including:

- restricting the obligation to two hour-long **trading windows** each day;
- a **volume cap** removing the obligation when an open position of 30MW or greater has been reached;
- allowing a **5 minute reload time** following acceptance of a bid or offer before being required to post a new bid and offer;
- a **fast market rule** removing the obligation if the price moves by more than 4% in a trading window;

- slightly wider **bid-offer spreads** for baseload products.

We have modelled the impact of these changes on our estimate of the costs faced by obligated licensees and this has reduced our estimate of the potential costs faced by each market maker from £15m per annum to over £8m per annum. This is still significantly greater than Ofgem's high case estimate, the main difference being we believe that obligated parties will need to close positions promptly, though not necessarily immediately, in order to manage value at risk.

Our estimates of the potential costs do not include increased costs from increased market price volatility. There are a number of reasons to believe that power price volatility is likely to increase in future years:

- The share of intermittent renewables in the GB generation mix is set to increase substantially as the UK strives to meet its 2020 renewable energy target. This can be expected to increase the volatility of spot power prices as abundance of low marginal cost renewable energy drive prices to very low or negative levels in some periods. Since wind output can vary substantially on monthly, seasonal and even annual levels, it is reasonable to expect that price volatility in some forward power products would also increase.

- Very low prices in some periods due to abundant renewable power will mean that peaking generation will have to recover its fixed and investment costs over a lower number of periods, thus increasing peak prices and therefore also price volatility.

- Ofgem is considering reforms to the GB electricity cash-out arrangements to ensure that prices reflect the full value of lost load. If implemented, this is likely to result in more peaky cash-out prices, which may also result in more peaky spot and forward prices.

- The margin of available capacity over demand, which tends to suppress mark-ups of prices over system marginal cost in peak periods, is widely expected to fall as many of the generation plant covered by Industrial Emissions Directive (IED) are forced to retire or drastically reduce their running hours. This can be expected to make peak prices higher and more volatile, increasing overall price volatility.

- New low-carbon generation plant built under Contracts for Difference (CfDs), some of which will be struck against forward prices, will create a significant base of generation capacity that is insensitive to falling market prices. This may increase the volatility of both spot and forward prices, as the price elasticity of supply for those plants would be zero.

Although some of the factors set out above relate directly to price volatility in the spot and balancing markets, it is likely that some volatility in spot and balancing prices would feed into the near-term part of the forward curve.

The cap on bid-offer spreads is specified as a percentage of the power price. This means that remuneration for market making activities would be lower at lower power prices. However, it does not necessarily follow that price volatility would be proportionately lower at lower power prices. The possibility of abundant low marginal cost renewable generation sending prices to near zero or even negative levels in some periods clearly demonstrates this. This is already happening in Germany and can be expected to happen more in the GB market in the coming years.

It is likely that the companies subject to the market making obligation would not be able to recoup the full costs of market making in many periods in the future due to the cap on bid-offer spreads.

European financial legislation

Ofgem has recognised that if market making changed the categorisation of an obligated licensee under European financial legislation, for example by exceeding the EMIR clearing threshold or by becoming a MiFID investment firm, then the licensee could face significant costs. The final design allows for Ofgem to carry out a review of the market making obligation in the event of an obligated licensee being materially and adversely affected in this manner and we would expect the obligation to be amended or removed completely in such circumstances.

Comparing costs to benefits

Ofgem suggests that on the basis of the 'Secure and Promote' proposals costing £19m per annum that they could produce benefits through reductions in operational costs and/or profits which could outweigh the costs. If, as we have suggested above, Ofgem has significantly underestimated the risks and costs associated with the market making obligation, it could become doubtful whether sufficient benefits would be realised to outweigh the likely level of costs.

Question 6: Do you agree with our evaluation of the risks and unintended consequences of our Secure and Promote proposals?

Supplier Market Access rules may remove volumes from the market

We do not anticipate that the Supplier Market Access rules will significantly impact overall volumes in the market. Their implementation should improve the competitiveness of small independent suppliers and enable them to take some volume from the larger suppliers. This in turn could encourage more small participants into the market to the benefit of final customers.

Accessibility for smaller firms may remain constrained

We believe that the Supplier Market Access rules will facilitate entry and competition by smaller suppliers by addressing directly the specific issues faced by these firms. Credit and collateral will always be key for small suppliers, and we think the terms offered to them through the Supplier Market Access rules should facilitate sufficient market entry.

Market making has limited effect on volumes

We agree that market making does not need to lead to a large increase in traded volumes to be successful. Market making could improve the robustness of reference prices by concentrating liquidity in particular trading periods and thus could achieve its aims without a substantial increase in overall volumes traded across all forward market products.

Risk of distortion to market price

If licensees are obligated to market make with bid-offer spreads that do not reflect market conditions, and as a result could be forced into unprofitable trades when posting bids and offers around their view of market prices, then there is a risk that the prices they post are not reflective of their view of market prices. It is essential that bid-offer spreads can be set at levels reflecting changing market conditions.

Risk of decreasing liquidity outside trading windows

We agree that increasing activity in trading windows will make them more attractive for trading and this could result in existing activity in other periods moving into the windows. We do not believe that this should give rise to concern as overall trading volumes are likely to increase and firms will still be able to trade at other times should they wish to do so.

Annex 3

LIQUIDITY IN THE WHOLESALE ELECTRICITY MARKET (SPECIAL CONDITION AA OF THE ELECTRICITY GENERATION LICENCE): DRAFT GUIDANCE

SCOTTISHPOWER RESPONSE

Obligated licensees

The guidance states that Ofgem will review the list of licensees to be subject to the obligation on an ongoing basis to ensure that it is appropriate and that in Ofgem's view the initial set of licensees who are to be subject to the obligation are better placed to meet the requirements of the licence condition at proportionate cost and risk than other market participants.

In relation to the market making obligation Ofgem has identified generation market share and domestic supply market share as key factors in deciding whether or not a licensee should be subject to the obligation. In the interests of regulatory certainty we think Ofgem should include in the guidance the level of generation market share and the level of domestic supply market share below which a licensee would not be obligated to market make. This would make it easier for both obligated and potentially obligated licensees to understand the implications of significant changes in the size of their generation and domestic supply businesses. It would also ensure compliance with the requirements of Directive 2009/72/EC regarding public service obligations[2].

An additional factor highlighted by Ofgem is whether a licensee will face disproportionate costs and risks in meeting the licence condition. We think Ofgem should provide more detail in the guidance as to how it will assess whether costs are disproportionate. For example, we would suggest that the key issue here is the risk of distortion of competition, and the assessment should consider whether the licensee would be placed at a significant competitive disadvantage relative to either obligated licensees or non-obligated licensees. This is likely to require an assessment of which markets obligated licensees are likely to be able to recover their costs from and their respective shares of those markets, as well as the absolute cost of the obligation.

The four factors listed by Ofgem effectively allow for a 'reopener' where the market share or business structure of obligated or non-obligated parties is subject to significant and sustained change. We think it is important that Ofgem also allow for a reopener where there is evidence that the costs and risks incurred by obligated parties have changed significantly (either as a result of under-estimates in the original impact assessment or changing market conditions). Both of these factors – absolute costs and relative market shares – are relevant to the assessment of proportionality, and if there is a significant change in either, this should be grounds for a re-opener. If any of the initial set of licensees who is subject to the obligation is able to demonstrate that they are facing disproportionate costs and risks in continuing to meet the licence condition, they should be able to apply to Ofgem to have the obligation removed. In extreme cases (supported by appropriate predetermined evidence), they should also be able to apply for immediate suspension of the obligation pending Ofgem's decision.

[2] Article 3.2 of Directive 2009/72/EC requires that public service obligations "shall be clearly defined, transparent, non-discriminatory, verifiable and shall guarantee equality of access for electricity undertakings of the Community to national consumers"

Supplier Market Access rules

We welcome the publishing, and monthly updating, of a list of Eligible Suppliers who are able to benefit from treatment under the Supplier Market Access rules. This provides clarity to obligated licensees and a quick and simple process for small suppliers seeking to become Eligible Suppliers. However, the definition of an Eligible Supplier in the licence condition and guidance needs to be clarified to make it clearer that if a supplier is removed from Ofgem's list then this has immediate effect and the supplier is not able to benefit from the Supplier Market Access rules for the remainder of the year.

Market making obligation

Paragraph 3.16 of the draft guidance quotes paragraph 10 of Schedule B to the licence condition. As explained in Annex 1 to this response, we think that there is a drafting error in this paragraph. If so, the guidance document will need to be amended accordingly.

ScottishPower
18 December 2013