Graham Knowles,
Wholesale Market Performance,
Ofgem, 9 Millbank, London, SW1P 3GE.

Email to: gb.markets@ofgem.gov.uk

19 December 2013

Dear Graham,

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

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

Background

EDF Energy supports measures that enhance liquidity; however this form of intervention is unprecedented in the history of regulated wholesale markets. EDF Energy has argued throughout the long debate that liquidity has been driven by factors outside the energy market and in particular access to credit for new suppliers. We have no reason to believe that (a) external "shocks" to the market will cease to occur or (b) they will not have a recognisable impact on liquidity. Furthermore, liquidity has not at any period in time been in a state of "equilibrium" (as suggested in the Impact Assessment). Instead we can imagine scenarios where liquidity could naturally increase e.g. plant closure after 2015, changes in asset ownership, and changes in financial markets facilitating entry into commodities trading. We do not support the assumption that liquidity will remain at its present levels.

The chart bellow illustrates how liquidity has changed including our understanding of its drivers over the last nine years.

Figure 1: Drivers for liquidity

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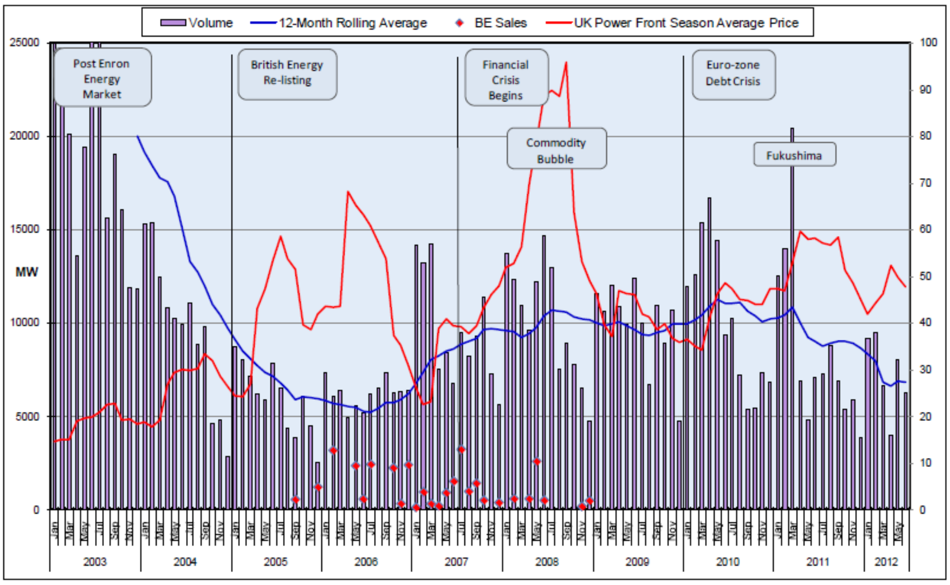


EDF Energy's Comments on the Proposed Licence condition

We agree that the draft licence condition broadly matches the policy intent. We have however, provided some drafting comments in the Annex of our response. We believe that Ofgem will need to carefully consider how the licence is drafted in order to reflect the policy intent in particular:

- The reference price, from which the 4% price change is calculated, in order to determine when a fast market is triggered, needs to be redefined.
- Additional clarity on what information needs to be recorded/reported, in relation to instances where a fast market is called is needed.

As drafted the specified peak load bid offer spreads are set incorrectly and will have a negative impact on the market that is likely to distort prices. This we believe is against the relevant objectives defined in AA.4 of the draft licence condition, in particular the availability of "robust reference prices." The bid offer spreads as presented are too narrow as

- Inherent risks associated with peak load pricing will naturally lead to wider bid offer spreads. Ofgem has accepted this point in the differences between base and peak load in the proposal. However, even for the front season, the peak bid-offer spread has always been more than twice the baseload spread even in times of high liquidity in baseload products. Any attempt by the regulator to "artificially" narrow the gap will inevitably lead to a distortion of the natural competitive process.

- Around 17.5GW of flexible plant on the system is owned outside of the obligated parties. This is a substantial quantity of capacity which does not have the obligation on it. Therefore we cannot see the obligation contributes to the robustness of peak prices, as defined in the stated objective of this intervention

- Peak load products are very difficult to price given the complex interaction of input costs. If we assumed a perfect market, the peak power price will be set by the marginal plant. As the price of input fuels changes (absolute price of carbon, coal and gas, relative prices of coal and gas), the marginal plant will change (and may do so on an intra-day basis). To manage this, units which are close to the money would need to continually trade both the peak power and the underlying fuel/carbon whenever the asset changes from being in/out of the money. This is an expensive process, and means that peak liquidity is concentrated in the shorter term when there is far more certainty as to what plant will be required to generate.

We would suggest the figures defined in Table 1 in Section 8 of the draft licence condition be fixed as the permanent spread for peak products summarised in table 1:

Table 1 Suggested Bid Offer Spreads Peak Products

Month+1	**0.9%**
Month+2	**0.9%**
Quarter+1	**0.9%**
Season+1	**0.9%**
Season+2	**0.9%**
Season+3	**1.2%**
Season+4	**N/A**

In conclusion we want Ofgem to set some clearly defined success measures within the licence which could be reviewed after a suitable period of time. Finally, we are not protected against further regulatory requirements as market makers, for example narrowing bands or expanding the product range. We would like this position clarified.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Ravi Baga on 020 7752 2143, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

Angela Piearce
Corporate Policy and Regulation Director

Attachment

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

EDF Energy's response to your questions

Q1. Do you consider that the proposed licence modifications appropriately reflect the policy proposals as described in this chapter?

Peak Products
EDF Energy's opinion is that the Peak bid-offer (B/O) spreads should be increased to reflect the fundamental structure of the UK power market. Historical B/O spread analysis shows that Peak products exhibit wider B/O spreads and are less liquid than baseload products, with longer dated products demonstrating higher B/O spreads and lower liquidity. This demonstrated in figures 2 and 3.

Figure 2

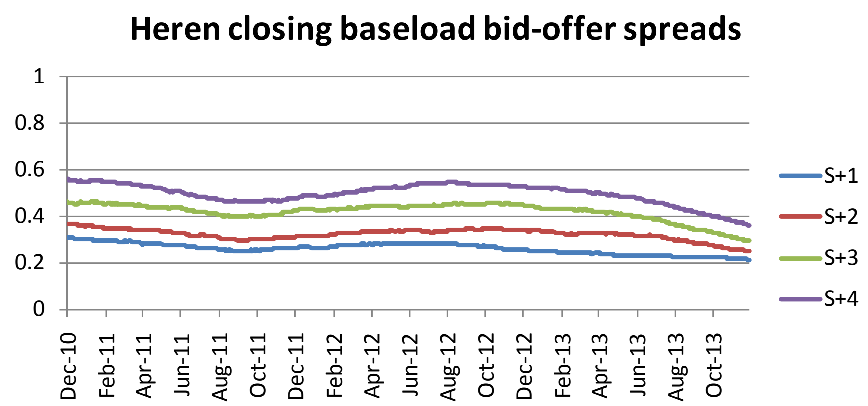
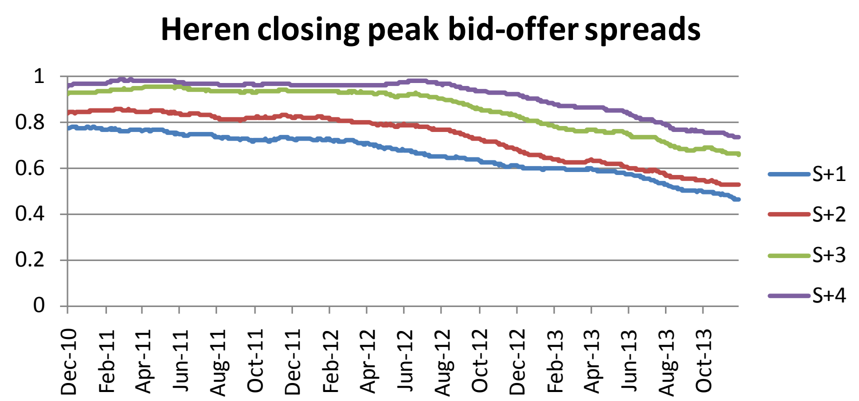
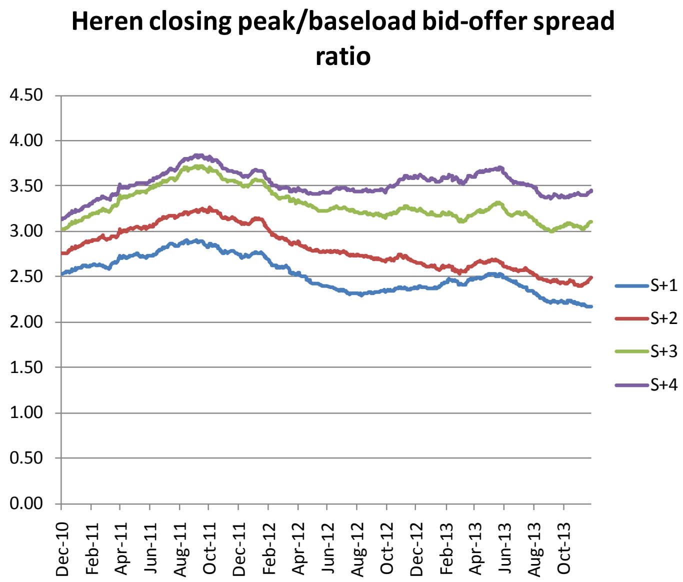


Figure 3



Historically the peak B/O spread has always been more than twice the baseload spread, even for shorter dated products such the front season. The ratio of peak-baseload B/O has been between 3 – 4 for S+4 and 2 – 3 for front season (Figure 4).

Figure 4



This results from the fact that demand is very different for baseload and peaks, with baseload being the significant market and therefore driving a hedging strategy where volume is focused around the baseload product. When it comes to hedging our demand, the two main products used for longer dated products are baseload and peak, with baseload being used to hedge to the major offpeak forecast level. Peaks are then traded to cover the difference between the baseload position and the demand across the peak period and because peak demand is less than 40% above baseload demand, one would expect peak liquidity to also be considerably lower which is indeed demonstrated using historical analysis (See figure 5 and 6).

Figure 5

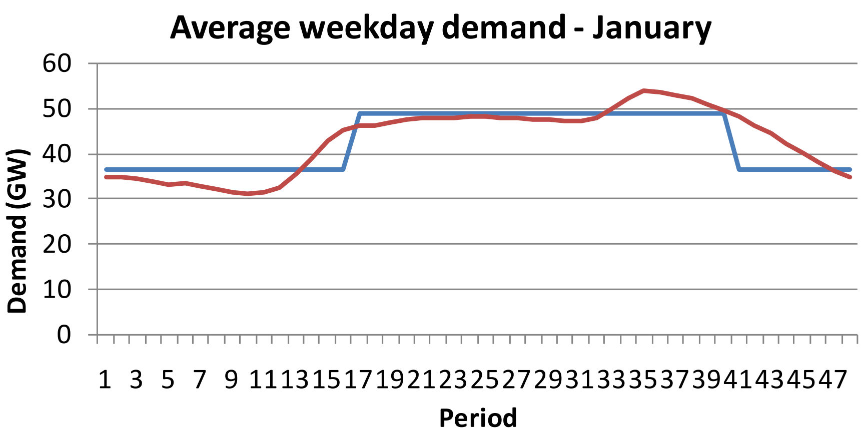
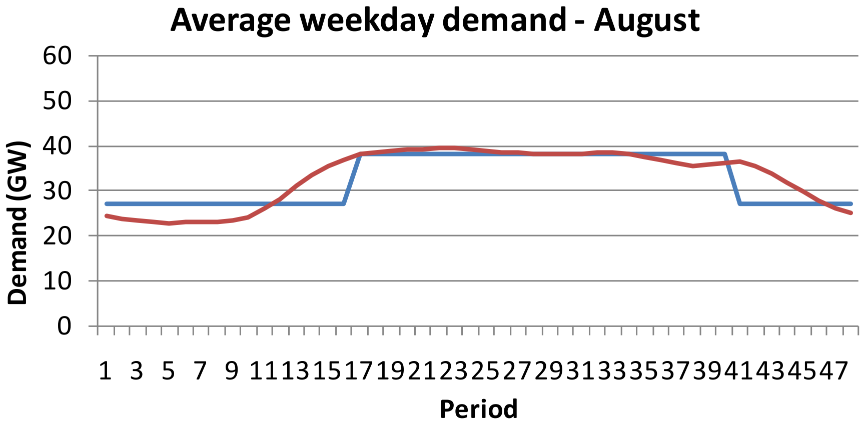


Figure 6



Further, there is considerable cost (and risk) in trading peaks further out along the curve, because. In a perfect market, the peak power price will be set by the marginal plant and as the price of fuels moves about (absolute price of coal and gas, relative prices of coal and gas), the marginal plant will change (and may do so on an intra-day basis). To manage this, units which are close to the money would need to continually trade both the peak power and the underlying fuel/carbon whenever the asset changes from being in/out of the money. This is an expensive and credit intensive process, and means that peak liquidity is concentrated in the shorter term when there is far more certainty as to what plant will be required to generate.

Practical aspects related to the market making obligation

We also note that there are practical aspects that need to be reviewed related to the suspension of the market making obligation in case of a fast market.

First, the reference price used to establish when a fast market is called would be better defined as the midpoint of the best bid and offer, shortly after the start of the market making window. Defining the reference price as the price that a product was first traded at within a trading window will lead to that the fast market threshold for illiquid product is in effect higher than 4%. For illiquid products, there will be situations where the implied market has moved during the window before the product actually trades. The price would have to move by another 4% before a fast market is actually called. This will not be a true reflection of price movement. A better method for setting the reference point from which the 4% price change is calculated would therefore be to take a snap shot, e.g. one minute into the market making window (when all bids/offers would have been posted), and base the 4% price change on the midpoint of the best bid and offer at that point.

Second, we seek clarity on what trades a licensee should base its decision on whether to call a fast market on, given that the decision should be based on trades on any qualifying platform. Individual licensees may not have visibility into trade details for platforms where that licensee is not active.

As a result, ideally, a decision to call a fast market should be taken centrally. This would further avoid instances where some licensees decide to call a fast market while others do not. It would also eliminate the administrative burden of having licensees report on when they have ceased to market make due to a fast market - and for Ofgem to be the judge of whether this is acceptable, in cases where not all licensees do call a fast market. (We are aware that Ofgem have made it clear that Ofgem will not be applying discretion about when a fast market is called and that Ofgem does not intend to notify licensees about when a fast market is in operation. We would still suggest that this is manages centrally, even if not by Ofgem.)

As an alternative, the Special Condition should reflect the limitations that licensees will face in terms of the trades that can in practice form the basis for calling a fast market.

In line with this, we also seek clarity on what trade details need to be recorded/reported in case of a fast market. Does this encompass trades that the licensee has entered into or all trades on those platforms where the licensee has visibility?

Other aspects could also be made clearer in the Special Condition. These are detailed in the comments below.

Proposed Special Condition AA: Liquidity in the Wholesale Electricity Market

EDF Energy's comments and proposed amendments

LCond	**Paragraph**	**Comment; and Proposed amendments**
AA	AA.1	*"Relevant Licensees"* Using defined terms already in use within the Generation Licence should be avoided as in this case in SLC16A.
	AA.4	*"Products"* Greater clarity would be provided if the defined terms "Schedule A Products" and "Schedule B Products" were used.
	AA.5	*"Relevant Licensee"* For consistency should read "means the holder of a generation licence granted or treated granted under section 6(1)(a) of the Act"
Schedule A	2	It is not clear what form of acknowledgement is required.
	3	*"The licensee must send a written response to the Eligible Supplier within 20 working days of receipt of a Request. Where the licensee determines a Request is incomplete, the licensee must specify what information is required for the purposes of completing the Request. The number of working days following such notification taken by the Eligible Supplier to complete an incomplete Request will not count towards the 20 working day limit."* Greater clarity provided by proposed inclusions above.

LCond	Paragraph	Comment; and Proposed amendments
	5	*Insert "provided under paragraph 3" after "response" on line 4*
	6	*Insert "in writing" after "agree" on line 2* Greater clarity and can be used as evidence of closure.
	8	Delete the second "*must include*" on line 1 Typographical error
	9	"*and, if required by the Authority, the licensee must demonstrate to the Authority that it has done so.*" Not required. Licensees are under a general duty to be able to demonstrate compliance with all of its licence obligations.
	10	Insert "*provided under paragraph 4(i)*" after "offer" on line 1 Provides greater clarity.
	15	Omit the words *"(if any)"* Unclear requirement for wording. A risk needs to exist in order for it to be justifiable.
	16 (2)	Does the wording needed to cover a possible scenario whereby a supplier comes off the "Eligible Supplier" list during negotiations?
Schedule B	All	*"Products"* The proposed definition of "Products" states that it includes EACH of the products in the table. Therefore it is inappropriate for licence condition wording to use the defined term "Product" when it is actually referring to only one of the products on the list and not all of them. For example, under paragraph 3 the use of the defined term in this case would mean that the licensee would be required to have bids and offers for all of the products on the same qualifying platform which is not the intent.

LCond	Paragraph	Comment; and Proposed amendments
		Furthermore the Licence condition has three defined terms for "Products" which is inappropriate. We would suggest the use of the defined terms "Schedule A Products" and "Schedule B Products".
	2	Move "*subject to paragraphs 7 and 10*" to the beginning of the paragraph.
	4	Capital S required for "schedule B"
	5	Suggest that "in relation to which" is replaced with "where"
	6	We need clarification on what is meant by "accepted", in light of the non-MTF workflows implemented by brokers as a consequence of financial regulation (EMIR) and the lag between the point when trades are "accepted" on screen and the point that they are actually executed at the brokers' discretion.
	7 (a)	The reference price used to establish when a fast market is called would be better defined as "the midpoint of the best bid and offer, one minute from the start of the market making window". Defining the reference price as "the price at which the Product was first so traded within that trading window" will lead to that the fast market threshold for illiquid product is in effect higher than 4%. This will be the case for illiquid products. For these products, there could be situations where the implied market has moved by, say 2%, in the window before the product actually trades. The price would have to move by another 4% before a fast market is actually called. This will not be a true reflection of price movement. A better method for setting the reference point from which the 4% price change is calculated would therefore be to take a snap shot one minute into the market making window (when all bids/offers would have been posted) and base the 4% price change on the midpoint of the best bid and offer. We seek clarity as to what trades a licensee should base its decision on whether to call a fast market on, given that "such trades may have been made by the same or different persons and on the same or different qualifying platforms." A licensee may not have visibility into prices of trades for platforms where that licensee is not active. Alternatively, there is a need to recognise the limitations of what individual licensees can monitor.

LCond	Paragraph	Comment; and Proposed amendments
		(Our view is as noted that the activation of a fast market should be based on a centralised decision.) Furthermore, it is unclear how a licensee should interpret the use of the word "*traded*". Does this mean where a bid or offer is accepted? It is also unclear as to the use of the word "*made*" in line 5.
	7 b	In line with the above, we need additional clarity on what is meant by "the trades". It will not be possible for licensees to monitor prices on all qualifying platforms. Do licensees record and report details of its own trades or details of trades also for the rest of the market (for the platforms where the licensee is able to do so)?
	8	As noted, our view is that the peak spreads are too narrow. In addition : Insert "posted" after "between the" on line 1. Insert "for that Product set out" after "percentage" in line 2 of (i) and in (ii).
	9	This paragraph could be made clearer in order to reflect that a licensee must be willing to trade in clip sizes of 5 MW and that the max size that licensees must execute is 10 MW.
	10 (a)	Current wording states "exceeds 30MW" whereas the policy document states the threshold is at 30MW. Second, this paragraph could be made clearer in general, e.g.: "The licensee may decide to cease posting bids and offers for a particular Product if a net volume of 30 MW has been traded in that Product."

LCond	Paragraph	Comment; and Proposed amendments
	10 (b)(i)	Replace *" the traded bid volume and traded offer volume in a trading window are the total volumes of a Product for which the licensee's offers respectively to buy and to sell, on any one or more qualifying platforms, have been accepted in the trading window,"* with *" the traded bid volume and traded offer volume in a trading window are the total accepted volumes of a Product for which the licensee offered respectively to buy and to sell, on any one or more qualifying platforms in the trading window,*
	10 (b)(ii)	Our view is that this paragraph should be deleted. If a licensee trades a volume that exceeds the 10 MW obligation, the licensee should still be allowed to count that volume towards the 30 MW volume cap.
	11	We believe the wording should be amended to appropriately reflect not the ability of the licensee in complying with the obligation but rather the impact of complying with the obligation as a consequence of any amendment or replacement of MiFID or EMIR. Proposed wording is *"Where the licensee considers that any amendment or replacement of MiFID or EMIR may have a material and adverse impact on it complying with this Schedule B, the licensee may submit to the Authority a request (which for the avoidance of doubt shall not bind the Authority) to undertake a review of the provisions of Schedule B."*
Schedule C	1, 4, Schedule B	In line with our other comments related to a potential fast market, we need additional clarity on what trade details need to be recorded/reported in case of a fast market. Does this encompass trades that the licensee has entered into or all trades on those platforms where the licensee has visibility?

EDF Energy
December 2013