

POWER TRADING FORUM



**Market Design Project
Meeting with Potential Service Providers.**

**Paul Beynon
Chairman – PTF
17th August 2006**

Tackling the decline in liquidity

- Mandate from the industry to provide recommendations for the enhancement of forward liquidity in the UK Power wholesale market
- Focussed on encouraging both existing power trading counterparties, and on attracting new risk capital
- Solution must anticipate developments in UK energy sector and developments in continental-Europe

Tackling the Decline in Liquidity (cont'd)

- Short term fix not an option
- Government and regulators taking a keen interest
- The result is a series of recommendations that will need a minimum of one service provider to participate in designing and implementing a solution

Steering Group

- Comprised of participants from a wide variety of market segments
- Significant commitment in time and effort
- Terms of Reference
- Fully transparent process – all minutes and papers available on FOA website

Energy Exchange

- SG prefers a structured energy exchange with clearing as the preferred mechanism.
- Physical and cash settled forward/futures contracts in the same trading/clearing location
- Margin offset against products traded on other exchanges would be a bonus
- In principle agreement to recommend to the industry as a whole to commit to mandatory clearing in prompt timescales only (prompt defined as balance of week plus one).
- Flexible product suite

Energy Exchange (cont'd)

- In order to gain wide acceptance
 - the clearing mechanism has to be backed by an =>A rated counterparty
 - seamless platform from forward timescales through physical delivery
 - margin offsets must be available
 - open interest publication, EFP/EFS facility essential
 - margin algorithms should reflect the volatility term structure evident in the power market

Energy Exchange (cont'd)

- The solution will have to provide commitment to developing an index product that satisfies the SG criteria, including:
 - a continuous window,
 - a “blind” power auction, and
 - a gas and Spark algorithm (eventually including Dark Spreads).

Spark Spreads

- SG consider financially settled spark spread would have a high degree of success
- 60-80% of proprietary positions carried as spark spreads at one time or another
- Provides unique trading relationship with natural gas for speculators requiring long term exposure to UK energy complex

Options/Shape

- No options market in UK power
- Market structure does not allow for accurate pricing
- Market naturally suited to options trading as outturn of power stations/demand is not fixed
- Without the granularity of hourly shape, options pricing cannot be achieved accurately

Reference Price

- Current reference prices not considered robust or trustworthy
- No single benchmark at the moment
- Essential for success of cash settled forward contracts - a robust and universally accepted reference price must be created
- Trading platform and data dissemination are key factors
- Oversight and governance

Reference Price (cont'd)

- Real-time (short window)
- Auditable
- Replicable
- Zero/minimal basis risk between forward and spot

Proposed Structures

- Significantly changed day-ahead continuous

Or

- Day Ahead Auction
 - See handouts

Summary

- Steering Group agreement on all aspects with exception of the reference price
- Fundamental change to market whichever path is taken
- Establishment of cash settled forward contracts is key – based on the agreed reference price

What We Want From You

- The practical solution to fit the 'wish list'
- Fulfil the criteria as outlined – particularly with regard to building a robust and trusted reference price
- Seamless platform from forward trading to gate closure
- Work with system operator to remove 3rd party nomination risk
- Strong and stable credit platform
- Product suite that provides the market with one solution
- Involvement in market oversight for active participants

What You Want From us?

- We need to know what you want
 - Minimum volumes?
 - Technology investments?
 - Commitments from the market?
 - Others?

Next Steps 2

- Interested parties should contact the FOA with their high level solutions by the middle of September
- SG seek “buy in” from senior commercial heads for the investment required. Early October
- Industry meeting November 22nd - SG present completed project and seek mandate to implement.
- November 22nd - PTF Issue criteria for selection of preferred supplier.
- End Q1 07 - design and implementation phase having chosen supplier

Contact

- Paul Beynon – paul.beynon@rwe.com
- Clive Furness – clive@contango.co.uk
- Sav Kanagasundaram – sav@contango.co.uk