Argus response to questions in the Ofgem consultation document on “Liquidity Proposals for the GB wholesale electricity market”

Ofgem consultation Ref 22/10

Contents

Executive summary

Liquidity develops in markets when they are useful to the participants. For example, the German electricity market has high liquidity because Germany borders many other European countries and electricity is traded across these frontiers. This, in turn, has led to German electricity markets being used extensively for price discovery and risk management in many other countries. The infrastructure to support similar levels of interconnection with the UK is being developed, with projects such as the BritNed interconnector scheduled for completion in 2011-12. Further projects have been proposed.

BritNed could have a significant impact on power market liquidity because it will create an arbitrage market between two countries in which gas-fired generation dominates and which have liquid natural gas markets — the UK, with its National Balancing Point (NBP), and the Netherlands, where gas trades through the Title Transfer Facility (TTF).

The perceived problems of liquidity in the British wholesale electricity markets are a direct reflection of the usefulness of the markets. The markets themselves will not be made more useful by forcing participants to trade on them. However, Ofgem can encourage the development of useful markets and therefore higher liquidity by obliging market participants to trade more openly, without dictating the form of trade or prescribing specific trading platforms. Ofgem would then be playing a valuable role by levelling the playing field between market participants and ensuring full and even market participation.

Actions to achieve this could include obliging participants to trade with one another and ensuring that smaller participants are able to trade on even terms with larger participants. Market levelling initiatives such as direct trading obligations, most likely in combination with a market maker role for the "big 6", would serve these needs well.

In considering the usefulness of the wholesale electricity market to existing and prospective market participants, it is imperative that any structural or regulatory changes aimed at benefiting one class of participants is not unduly restrictive on others, or on the functioning of the wholesale market. More specifically, obligations imposed on the "big 6" to encourage new entrants in the electricity retail sector must not discourage trade or physical infrastructure investment by those big 6.

Extending regulation beyond the creation of a level playing field by dictating the market's dimensions, dynamics and size can have unintended consequences that reduce market liquidity or effectiveness or even distort the market levels. As such, Argus does not believe that initiatives such as mandatory auctions or self-supply restrictions will be the most effective approach for Ofgem to achieve its objectives.

About Argus

Argus Media Limited (Argus) is a leading independently owned global energy market price reporting and market intelligence service. Argus is a UK limited company owned entirely by its employees and the family of the founder. It employs over 350 people worldwide including over 50 freelance journalists.

Argus offices

Argus produces daily price assessments for the spot energy markets. Argus polls market participants in a wide range of markets, producing expert assessments of the prevailing spot market price based on this information. These published prices are widely used within industry and government wherever an independent spot market price assessment is required. Argus provides extensive coverage of the European natural gas, power, coal and emissions markets, and has recently led the price reporting sector in increasing transparency of the over-the-counter (OTC) gas and electricity markets in central and eastern Europe.

The publication of reliable energy price assessments is a full-time enterprise that is provided by price reporting agencies (PRAs). Argus carries out rigorous checks and safeguards to ensure the integrity of its assessments. PRAs are well placed to provide this service to the industry, as they do not suffer from any conflicts of interest related to market price levels or market liquidity. By contrast, direct market participants or brokers are potentially conflicted in the provision of price assessments and indexes.

Argus is committed to transparency in markets. The focus of the company is to provide price discovery for physical energy markets. Argus is committed to transparency of methodology, transparency of information and transparency of process. Argus makes all its methodologies publicly available online at www.argusmedia.com/methodology. Argus works with regulators and other government departments in the UK and elsewhere to help them understand the transparency that already exists for market participants, and how Argus produces reliable price assessments.

The publication of energy prices enables all participants in the market to obtain information on an equal basis and acts to level the playing field between them. And the energy industry, regulators and governments expect Argus to do all that it can to ensure the accuracy of the information it provides.

To support the maintenance of high standards, Argus operates to a strict internal compliance and ethics policy. Its internal compliance staff conduct regular spot audits to ensure that Argus reporters and editors adhere to the reporting procedures and published methodologies. All Argus staff undergo training throughout their time at the company to ensure that they are qualified to meet Argus' goals. This process has been recognised by the UK government's Investors in People award. Argus has contingency plans in place to ensure that it continues to report on markets and make them transparent in emergency situations, and has full disaster recovery plans.

<u>Argus response to questions</u>

Chapter One: Defining the problem

Question 1: Do you agree that the harm caused by low levels of liquidity is sufficient to merit policy intervention, if such low levels persist?

1.1. Argus agrees that if smaller participants and potential new entrants are genuinely unable to access a level playing field, potentially resulting from anti-competitive practice, then policy intervention is necessary. However, Ofgem should bear in mind that liquidity should not be enforced in a way that has unintended consequences that distort market dynamics or pricing, to the detriment of the consumer.

Question 2: Do you agree that the focus should be on electricity markets?

1.2. Yes, because electricity is a unique commodity with specific liquidity issues.

Chapter Two: Success criteria for market initiatives

Question 1: Do you think our high level success criteria are appropriate?

2.1. Success is best defined in terms of achievement of a more level playing field for market participants and increased liquidity of trade.

2.2. Argus has the following specific responses to the Ofgem success criteria proposals:

2.2.1. *High volumes traded in standard products.* Standard products are not necessarily the solution for smaller participants, which are concerned about low liquidity and have expressed a need for tailored products. Energy consumers are concerned that standard baseload and peak products do not always accommodate their bespoke demand profiles. Volumes in standard products alone are, therefore, not necessarily the best or only guide to liquidity.

2.2.2. *Availability of key longer dated products and/or financial derivatives.* Liquidity in longer-dated physical forward products is critical to overall market liquidity. Success of these products can be measured through outright liquidity data and through reporting on any narrowing of bid-offer spreads, which clearly indicates rising liquidity.

2.2.3. *Use of trading platforms by small/independent suppliers.* Trading platforms in themselves are not a necessary ingredient of market liquidity, and it is important to note that a trading platform need not be an exchange. Many successful liquid markets exist where an exchange plays a minor role or no role. For example, EEX in Germany sees growth in clearing OTC trades rather than in on-exchange trading, and the French forward market is almost entirely OTC. The bulk of forward or forward physical trade in the EU is carried out in OTC markets, usually through brokers, rather than on exchanges. Aggregators of trading information from brokers and other platforms have evolved in the market, making it easier for smaller participants to become involved. This solution is developing in the market through innovation, without the need for the prescribed use of certain platforms or exchanges.

2.2.4. *Positive feedback from small/independent suppliers and potential entrants.* Argus believes that positive feedback from industrial buyers is particularly important as they have expressed concerns about market liquidity and fair prices.

Question 2: Do you have views on how these can be quantified and the appropriate target level of performance?

2.3. No comment

Question 3: When should market success be judged?

2.4. Ofgem should bear in mind the lead time required for a change in liquidity to occur. Actions such as direct trading obligations should have a measurable impact in six months or less, but it may take 18-24 months for a material change in other areas of liquidity to occur. This time frame would also allow for any liquidity benefits from increasing interconnection with nearby mainland European markets to emerge.

Chapter Three: Overview of the possible remedies

Question 1: Are there any other policy options, beyond those set out in chapters 4-8, which merit attention?

3.1. No comment.

Chapter Four: Direct trading obligation

Question 1: Is a direct trading obligation an appropriate solution to the problems related to wholesale market liquidity?

4.1. A direct trading obligation is an effective way to increase liquidity. By obliging major market participants to trade openly, increased liquidity is almost inevitable. It would add to the liquidity in OTC markets underpinning the provision of trusted reference prices, as long as direct trading obligations do not prescribe the form or conditions of trade, such as certain platforms or exchanges. A direct trading obligation would require additional market oversight in order to prevent non-compliance.

Question 2: Which licensees should be subject to the obligation?

4.2. The big 6, but Ofgem would need to oblige them to carry out direct trading at equivalent or higher levels than they do already, in order to safeguard against the big 6 reducing trading volumes to prescribed levels.

Question 3: What requirements should be put in place relating to products, pricing, collateral and other conditions of trade?

4.3. Ofgem should not be overly prescriptive in defining the form or conditions of trade, as this would unduly constrain the operation of a direct trading obligation and thereby limit its effectiveness. Ofgem should allow a broad range of product options in the UK physical and physical forward markets.

4.4. Specifically regarding pricing, market participants experience no problem in obtaining reference prices, as a large number of reference prices are available to the market. Reference prices include those published by independent PRAs such as Argus, N2Ex trade levels and volume-weighted indexes from the London Energy Brokers Association (Leba). Ofgem could ensure that fair pricing is being attained by tracking the price levels of trades against an independent benchmark or benchmarks. The use of independent price benchmarks such as those published by Argus should derive from their credibility within the industry, rather than being imposed by Ofgem.

Question 4: Is it appropriate to extend the obligation to cover generation purchases?

4.5. No comment

Question 5: What costs would this option impose?

4.6. This option would impose set-up costs on all participants but would not be so onerous as to act as a restriction in trade in itself. Additionally Ofgem would need funds to set up a small oversight role to police the operation of the trading obligation requirements and its execution.

Chapter Five: Market making agent

Question 1: Is a market making arrangement of the kind set out in this chapter an appropriate solution to the problems related to wholesale market liquidity?

5.1. The market making arrangement would need to be executed with care.

5.2. The market making arrangement is not a necessary feature of a liquid market and would ideally be encouraged rather than mandated. Market makers perform an important function in providing liquidity, but this can occur on more than one trading platform in any given market. Such platforms could include regulated exchanges, a voice or electronic broker platform, or a purely OTC market. Any of these would serve the function of providing liquidity.

5.3. Predetermining and prescribing a standardised trading product can be counterproductive and may be inappropriate (see 2.2.1).

5.4. The direct trading obligation option has more advantages and fewer disadvantages than the market making agent option.

Question 2: What products should be made available through a market maker?

5.5. Prescribing products limits market innovation, and could stifle rather than promote liquidity.

Question 3: What volume obligation would be appropriate?

5.6. No comment

Question 4: Would the establishment of a "Market Making Agent" facilitate the introduction of market making?

5.7. No comment

Question 5: What costs would this option impose?

5.8. No comment

Chapter Six: Mandatory auctions

Question 1: Are mandatory auctions an appropriate solution to the problems related to wholesale market liquidity?

6.1. Mandatory auctions are not an appropriate solution as they would lead to product standardisation, would force liquidity into specific channels and may distort trading levels.

Question 2: How should the volume of generation subject to a mandatory auction be set?

6.2. No comment

Question 3: Who should be obliged to offer into the auction?

6.3. No comment

Question 4: What design features should be incorporated into the auction process and rules?

6.4. No comment

Chapter Seven: Self-supply restriction

Question 1: Is a self-supply restriction an appropriate solution to the problems related to wholesale market liquidity?

7.2. A self-supply restriction is not an appropriate option as it pre-supposes the level of trade that exists among vertically integrated utilities at present. And by imposing an absolute level of self-supply trade, Ofgem would be predetermining the level of open trade that would take part outside the vertically integrated utilities.

Question 2: Who would be covered by the self-supply restriction?

7.3. No comment

Question 3: How should the extent of a self-supply restriction be set? Should it relate only to the supply to domestic customers?

7.4. No comment

Question 4: Should a self-supply restriction be accompanied by measures to ensure that small participants have access to the products they need? If so, which products?

7.5. No comment

Question 5: How could the previous problems related to enforceability be overcome?

7.6. No comment

Question 6: What costs would this option impose?

7.7. No comment

Chapter Eight: Collateral requirements

Question 1: Do you think that any of the possible approaches outlined in this chapter have merit and should be pursued further?

8.1. Regulation is not appropriate on the specific issue of collateral. Ofgem should bear in mind the legitimate concern of larger market participants to the risks of trading with less financially secure independent suppliers. But the market itself is the best judge of whether letters of credit, non-standard approaches to collateral, credit insurance or other solutions are the best way to deal with this concern.

8.2. Forced clearing through a central counterparty (CCP) is not an appropriate approach for energy market trading, partly because of the need to standardise products to enable CCP clearing. Energy products are less suitable for standardisation and central clearing than some financial derivatives, and energy markets do not pose the same systemic risk as financial markets. Argus has responded to the European Commission regarding initiatives to enhance the resilience of over-the-counter (OTC) derivative markets in energy, such as standardisation and central clearing. This response is publicly available[1].

8.3. Standardising risk management would impose inflexible terms on the market, which is better able to innovate new forms of hedging and collateral without regulatory intervention. For example, some energy derivative products spontaneously moved towards CCP clearing to limit counterparty risk in response to the September 2008 credit crisis. This process required no regulatory intervention.

8.4. Several options outlined in the chapter on collateral requirements would increase the cost of trade, and thus damage liquidity. Intervention by the regulator would distort the market for risk management and credit.

Chapter Nine: Conclusions and next steps

Question 1: Do you agree with the proposed assessment criteria?

9.1. Argus agrees in particular with the first two criteria of improving the ability of small/independent suppliers to meet their wholesale energy purchasing and risk management; and improving overall liquidity in the wholesale electricity market, including liquidity along the forward curve. These two options combine a qualitative response from smaller market participants with a quantitative measure of overall liquidity.

9.2. Improving the ability of large consumers and independent generators to access appropriate wholesale liquidity is one way of measuring improved market efficiency, for instance with reference to potential new entrants on the supply side. An improvement in investment decisions, however, will depend on many factors other than market liquidity.

9.3. Argus agrees that proposals need to cause the least cost and disruption to efficient market outcomes, and must minimise unintended consequences.

Question 2: Which do you think is the best policy option or combination of options?

9.4. Ofgem can encourage the development of useful markets and therefore higher liquidity by obliging market participants to trade more openly, without dictating the form of trade or prescribing specific trading platforms. Ofgem would be playing a valuable role by encouraging full and even market participation. The best policy options to achieve this are:

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[1] "Possible initiatives to enhance the resilience of OTC derivatives markets: Argus Media response to the consultation document from the European Commission, 28 August 2009": http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/derivatives_derivatives/individual_respondents/argus_enpdf/_EN_1.0_&a=d

- 9.4.1. Encouraging large participants to trade with smaller participants through a direct trading obligation;

- 9.4.2. Encouraging a market maker role for the “big 6”.

9.5. Infrastructure projects that support connections between the UK and other markets, such as BritNed scheduled for completion in 2011-12, could have a significant impact on power market liquidity. BritNed will create an arbitrage market between two countries in which gas-fired generation dominates and which have liquid natural gas markets — NBP and TTF.

9.6. The perceived problems of liquidity in the UK wholesale electricity markets are a direct reflection of the usefulness of the markets. The markets themselves will not be made more useful by forcing participants to trade on them, or by prescribing the use of certain specified products and trading platforms.

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