Consumer Focus
Campaigning for a fair deal

Response to Ofgem's consultation on Liquidity Proposals for the GB wholesale electricity market

April 2010

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About Consumer Focus

Consumer Focus is the independent champion for consumers across England, Wales, Scotland, and (for postal consumers) in Northern Ireland. We operate across the whole of the economy, persuading businesses and public services to put consumers at the heart of what they do.

Consumer Focus was formed on 1 October 2008 through the merger of three organisations – energywatch, Postwatch and the National Consumer Council (including the Scottish and Welsh Consumer Councils). We are a statutory organisation that works in a devolved setting, with work priorities varying across different parts of the country, by all working to common strategic goals.

Through campaigning, advocacy and research, we champion consumers' interests in private and public sectors by working to secure fairer markets, greater value for money, and improved customer service. We have a particular focus on the interests of consumers in markets that are 'designated' by Government as requiring additional consumer advocacy. Currently these include energy and postal service consumers.

Consumer Focus also has a commitment to work on behalf of vulnerable and disadvantaged consumers, and a duty to work on issues of sustainable development.

Summary

We provide responses to the individual questions posed in your consultation later in this document. We first set out our view of the current state of the wholesale power market, how the market should meet the needs expected by consumers and what we believe needs to change to make this happen.

The current state of the market

We are pleased that Ofgem has correctly identified that the level of liquidity in the wholesale forward electricity market is too low and that the situation needs to improve. We note that it is of the view that the vicious cycle, where low levels of liquidity result in energy companies bypassing the wholesale market and entering into alternative trading arrangements, is 'well under way'[1]. We are encouraged by the recognition that a liquid wholesale market is vital to ensure the effective functioning of the complete electricity value chain and to ensure that the market is both competitive and contestable. The current state of the market is providing customers with suboptimal outcomes in terms higher prices and less choice and innovation. This situation must be rectified. The fact that Ofgem is now taking the concerns of small and independent market participants and consumers more seriously is to be commended.

Consumer Focus believes that the lack of liquidity in the wholesale forward electricity market is the major cause of a lack of competition and contestability in the energy market (as the purchase and sale of electricity and gas in GB essentially operates as a dual fuel market). It is not a coincidence that there has been no scale entry into the GB retail market for many years. The NETA system was established on the basis that a functioning and liquid wholesale market would allow all efficient and effective market participants to sell and procure the power they needed to meet their business requirements. Without a liquid forward electricity market, small and independent parties (and very importantly, those companies without both generation and supply businesses) will be unable to grow organically or, in some cases, enter the market at all. This, we believe, helps explain the lack of competitive pricing within the GB energy supply market and which may contribute to the 'leader/follower' behaviour we witness from the 'Big Six' energy suppliers when retail prices both rise and fall.

The lack of liquidity in the GB wholesale power market is also a principal concern for us as liquid forward markets play a crucial role in providing long term investment signals to the market. With the amount of investment envisaged in the electricity generation market in the coming years, in part to meet the Government's carbon emission reductions targets, it is crucial that credible investment signals are available to all market participants, not just a clique comprising the large energy companies. By having effective competition in the building of new generation assets this represents the best way to keep the costs to consumers as low as possible.

We are also very encouraged that this issue has been noted by the Government in the HMT/DECC Energy Market Assessment. We believe the following passages are worth quoting at length. The Energy Market Assessment stated that, 'The main reason for the lack of independent activity [in the electricity market] is likely to be the barriers to entry in both wholesale and retail markets. The primary barrier is low wholesale market liquidity'[2].

[1] Liquidity Proposals for the GB wholesale electricity market, Ofgem (February 2010) p5.
[2] Energy Market Assessment, HM Treasury (March 2010) p15.

Most importantly the Assessment defined the primary cause, 'The lack of liquidity arises from the vertically integrated companies 'self-supplying' their electricity (ie their supply arms purchase their electricity requirements from their generating arms) and/or entering into long-term contracts with independent generators, which ultimately means there are low volumes of electricity available to trade on the wholesale market'[3]. We are very pleased that the Government recognises what we and others have been saying for a long time.

There can be no excuse for failing to act to improve the current situation.

What is a liquid market and what should it to provide?

What we believe should be defined as a liquid wholesale market is very close to what Ofgem have previously stated. A liquid market is one which allows market participants to quickly buy or sell a commodity all along the curve without causing a significant change in its price and without incurring significant transaction costs.

It will also exhibit the following characteristics:

- a large number of buyers and sellers
- high levels of secondary trading (or churn)
- a large variety of different product availability, be it by maturity of contract, clip size, shape etc.

However, what we believe is most important is that liquid wholesale markets should provide confidence and a contestable market which provides benefits for end customers.

A liquid wholesale market should provide all market participants, including end customers, with confidence that the wholesale prices reflect underlying demand and supply fundamentals, ie they are both efficiently determined and fair. The lack of trading in the forward part of the wholesale market will naturally lead to these contracts attracting significant, and we would argue, excessive risk premiums due to a lack of price discovery. These prices are the ones which ultimately determine the prices that end users pay (due to energy companies' hedging strategies). There is no excuse for customers to be overcharged due to a failure by energy companies to trade.

A liquid wholesale market should also ensure that the market is contestable and competitive. At present the GB electricity market (both in generation and even more so in supply) is dominated by six large vertically integrated companies. This has been one of the consequences of the introduction of the NETA system at the beginning of the last decade. We believe that non-vertically integrated companies, in both generation and supply, should at least have a fighting chance of entering the market and growing organically as long as they are efficient. They, as well as large industrial buyers, should to a great extent be able to purchase or sell their energy requirements/surplus. By increasing the contestability of the market, as well as the competition within it, consumers should begin to see far greater benefits that the liberalisation of market was supposed to bring in terms of lower and efficient market prices, innovation and choice.

Finally, as touched on above, a liquid wholesale market should provide the efficient long-term investment signals to all market participants. This should then allow market participants to secure the long term energy supplies which consumers expect and meet the country's environmental obligations at lowest cost. Given the scenarios envisaged in Ofgem's Project Discovery documents it is all the more important that every aspect of the market functions efficiently otherwise consumers will end up paying twice for the:

[3] Ibid. p15.

1. inefficiently derived wholesale prices
2. various environmental subsidies and levies

Energy companies should not be allowed to blame rising retail prices solely on environmental obligations while there is still an illiquid wholesale power market which their trading behaviour is contributing to. We have discussed this issue of liquidity and importance for long term investment in greater detail in our response to Ofgem's consultation on Project Discovery policy options[4].

What needs to change?

We believe that policy intervention, be it a market initiative or a regulatory solution, is required to improve liquidity in the market and it needs to be implemented as soon as possible. The challenges, in terms of providing fairer prices to consumers and long-term investment, mean delaying policy intervention is damaging for the interests of consumers. It also represents an unnecessary and avoidable risk to securing long term and clean power supplies.

We are pessimistic about the ability of the various market-led initiatives to fundamentally improve liquidity in the wholesale market in the time required, if at all. This is especially true in the part of the wholesale market it is most required and where trading is at its thinnest; the forward market. We recognise the natural desire of any regulator to try and encourage industry to find its own solution before it intervenes in a market, but have limited sympathy for the 'wait and see' tactics that continue to be applied in this key policy area. Industry has been given an extremely extended grace period to get its house in order and has thus far failed to do so. It is not in the interests of the major players to open up the market to genuine competition and relying on them to do so voluntarily is likely to lead to continued market failure. As a result consumers pay over the odds.

Ofgem should consider publishing a precise deadline for any market initiative to deliver clearly stated objectives. This could act as a spur for the large energy utilities to get their act together and ensure that the market initiatives deliver the required outcomes expected by consumers.

However, in all likelihood we believe that a combination of two of the policy options that Ofgem has raised in its consultation document will be needed to fundamentally improve the GB wholesale power market. These two measures should aim to each meet the two separate objectives we believe are needed to improve outcomes for consumers:

1. Increase confidence in traded forward prices so that these reflect supply and demand fundamentals; therefore reducing the impounded risk premiums of these products which are unfairly passed through to end users. We believe current reported forward prices show that risk premiums are excessive in light of supply and demand fundamentals. It should also contribute towards improving long term investment decisions, thereby increasing market participants' ability to provide customers with secure long term supplies. We believe this can be viewed as improving overall market liquidity and as a relatively short term objective
2. To improve the contestability of the market both in supply and generation. To allow parties at least a fighting chance of competing without having to be a vertically integrated company thus providing the competitive pressure on the large established energy companies which is lacking at present. We also hope it will allow large Industrial and Commercial (I&C) buyers to access the market directly to procure their power needs (if they wish). We believe this can be viewed as

[4] **http://consumerfocus.org.uk/g/4le**

improving small market participants' ability to operate within the electricity market and can be viewed as a more medium/long term objective

Whatever measure is implemented, it will need to be carefully designed and effectively monitored to ensure that it is meeting the objective(s) set out above.

Views on consultation questions

CHAPTER: One

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?

Yes, the harm to competition, consumers and investment, signals caused by low levels of liquidity would demand a policy response. Development of policy proposals to increase liquidity should be given a very high priority by Ofgem. Consumers are paying inefficient and unnecessarily high prices as a consequence.

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

The lack of liquidity in the power market is more of a concern than in the wholesale gas market. However, the wholesale gas market should continue to be monitored to ensure that this market is functioning effectively (please see some of our suggestions on market monitoring later in this document). It is important to remember that the Business and Enterprise Select Committee report in 2008[5] recommended that Ofgem investigates the wholesale forward gas market and that if it were unable to reach any firm conclusions should consider a referral to the Competition Commission[6]. This is because there was widespread concern among various stakeholders that the wholesale gas market was not functioning efficiently. Attention should also be paid to the trading interactions between gas and power (spark spread trading) to ensure that liquidity in the wholesale gas market is not 'masked' by, what is essentially, power trading.

CHAPTER: Two

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

The four-point success criteria are broadly correct. While it is important that all aspects are met we would rank the separate indicators as follows (1 the most important, 4 the least):

1. Availability of key longer dated products and/or financial derivatives. This is because it is the forward market where trading is at its thinnest
2. High volumes traded in standard products
3. Positive feedback from small/independent suppliers and new entrants
4. Use of trading platforms by small/independent suppliers

It is important that the success criteria are specifically judged against the performance of the identified market initiatives (which must be able to meet the success criteria within the required timescale – please see more below).

Consumer Focus would add that it is important that the market success criteria are supplemented by two broad overriding objectives/outcomes that the wholesale market should provide. These are:

[5] House of Commons Business and Enterprise Committee, Energy prices, fuel poverty and Ofgem (16 July 2008)
[6] Ibid. p10

1. To increase confidence in traded forward prices so that these reflect supply and demand fundamentals; thereby reducing the impounded risk premiums of these products which are unfairly passed through to end users. Evidence that the risk premium is excessive is provided by the large spread between the bids and offers of longer dated contracts. For example, the bid offer spread for baseload contracts is close to £1MWh and even greater for peak contracts. The bid-offer spreads in the wholesale forward gas contracts are far tighter. As demonstrated, we believe current reported forward prices show that risk premiums are excessive in light of supply and demand fundamentals. It should also contribute towards improving long term investment decisions, thereby increasing market participants' ability to provide customers with secure long term supplies. It should not be the case that long term pricing signals are only available to the large vertically integrated companies and not all market participants. If costs to consumers are to be kept to a minimum it is important that all the market can compete to invest in the generation market, not just a small clique of large companies. We believe this can be viewed as improving overall market liquidity and can be viewed as a relatively short term objective.
2. To improve the contestability of the market both in supply and generation. To allow parties a reasonable opportunity of competing without having to be a vertically integrated company thus providing the competitive pressure on the large established energy companies which is lacking at present. We also hope it will allow large I&C buyers to access the market directly to procure their power needs (if they wish). We believe this can be viewed as improving small market participants' ability to operate within the electricity market and can be viewed as a more medium/long term objective.

It is important to note on the question of smaller players being able to access key longer dated contracts (point two) that it is the availability of these contracts which is important not necessarily their use/purchase. The practice of hedging prices very far ahead can result in sub optimal outcomes for consumers if they are entered into at historically high levels. Furthermore, prices further out along the curve will attract greater risk premiums due to the lack of trading activity. The price discovery process as a result will be impaired. It is our view that companies' hedging strategies must work in the interest of consumers.

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

Ofgem needs to ensure that indicators of the market initiatives are designed so that they measure any *direct* improvements these make to the state of the wholesale market.

There should also be analysis and measurement of wholesale market indicators to judge the health of the market. We believe it is very important to distinguish between power which is traded on the wholesale market (in the prompt and forward market) on an over the counter (OTC) intermediated market or exchange and on the 'off-market' ie contracts which are sold bilaterally and not via a broker, often internally between the same company's generation and supply arms. We have presented an information template to Ofgem that we hope will provide some answers as to how much power is traded away from the market. If this volume is too great it will inevitably restrict volumes from the wholesale forward market.

In addition, bid-offer spreads of long dated contracts (seasonal and annual forward and futures contracts) up to five years out on the curve should be measured as well as the overall churn ratio of the wholesale power market. We would add that viewing the overall churn ratio in isolation, as some of the larger energy companies seem to suggest, will be of marginal use. This is because the churn ratio does not indicate where electricity is actually being traded in the wholesale market (spot, prompt or forward). It could be the

case that a concentration of trading in one part of the market, say the prompt part, could inflate the overall churn ratio therefore masking the lack of trading in other parts of the market, ie in this case the forward market. We believe this scenario is occurring at present.

We think that Ofgem should quantify the views of small suppliers and independent market participants in questionnaires to help determine whether the market is sufficiently liquid and therefore contestable. We are therefore encouraged that Ofgem has already been proactively seeking the views of these market participants.

Question 3: When should market success be judged?

The timing is crucial. The priority for us is to achieve these objectives as soon as possible to increase the benefits of competition to customers. We therefore recommend 'fast-tracking' Ofgem's current proposed timetable.

We believe that a final decision on the progress on industry initiatives should and could be made by summer 2010 (by the end of August 2010). Within this time period Ofgem should continue to further develop all the proposed options with relevant stakeholders to allow policy options to be introduced as quickly as possible if required. If industry initiatives have failed to meet the required success criteria by this point Ofgem should then be in an advanced position to consult in more detail on the proposed options and be in position to consider implementation within the first half on 2011 (please see the graph on the following page which illustrates our view).

Ofgem should consider publishing a precise deadline for any market initiative to deliver clearly stated objectives. This could act as a spur for the large energy utilities to get their act together and ensure that the market initiatives deliver the required outcomes expected by consumers.

The main reason for advancing the timetable is because we have been waiting for an industry response since consumers raised this problem with Ofgem and DTI in 2004; nearly six years. The Power Trading Forum (PTF) provided the basis for an industry solution in October 2005. It has taken almost five years to just establish the new power exchange platform (N2EX) which was the result of the PTF's industry solution. There have also been further initiatives/reports since (the Business and Enterprise Committee Report 2008 for example) highlighting this issue as a very serious concern. In that time wholesale market liquidity, particularly in the forward market, has diminished considerably since self-supply restrictions were removed from licence conditions in 2004.

We consider that it is highly likely that the major players will try to drag out negotiations, and water down solutions, as reforms to liquidity that open the market to genuine contestability are clearly not in their commercial interests. Unfortunately, Ofgem's persistent unwillingness to refer matters to the Competition Commission is likely to give it a very weak bargaining hand in any negotiations – no one genuinely regards the likelihood of referral as a credible threat and this may make it all too likely that industry will successfully fend off or dilute any meaningful change by threatening or lodging objections to licence changes. In the absence of a credible risk of referral, we encourage you to look at alternative routes to deliver a robust solution quickly. Given the cross-party concern shown by Parliamentarians, and the high possibility of a further Energy Bill should the Government change following the forthcoming election, you may wish to consider whether seeking a statutory intervention would provide an alternative to pursuing licence changes.

The market initiatives that should be judged are (considering the timescales we would like to see adopted):

- N2EX

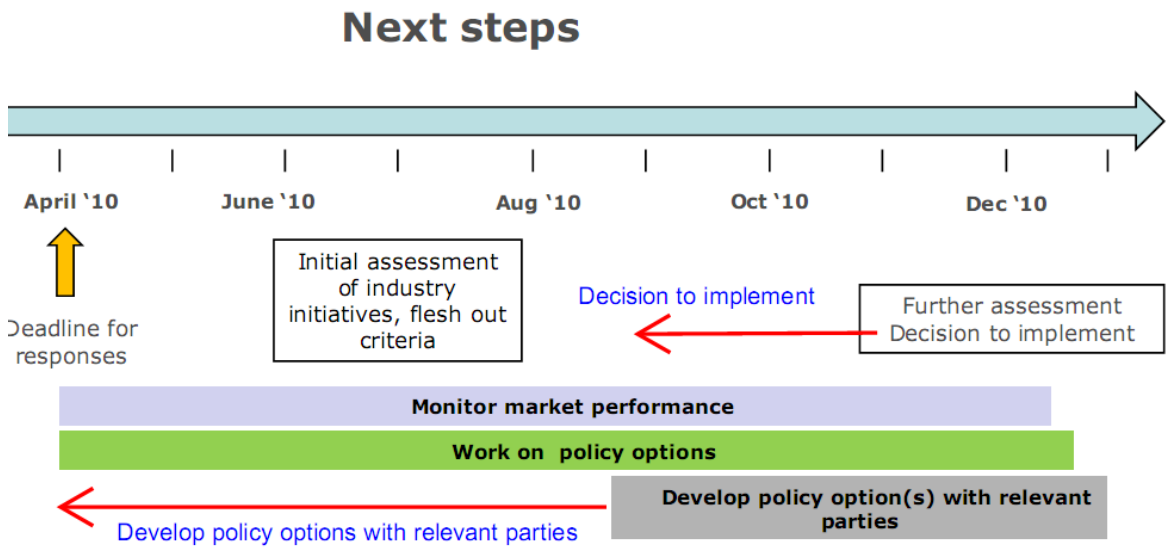
- APX intra spot market
- LEBA month ahead price index

The market coupling initiative at Britned, although welcome, will take too long to provide benefits to competition and consumers in the time needed (Britned is scheduled to begin in Q1 2011). We would also add that expectations for the establishment of a 1GW interconnector (which is not a great volume of power considering the size of the GB market) to materially increase liquidity should not be too great.

Furthermore we are of the view that that the main market initiative, the N2EX, is very unlikely to materially improve the level of liquidity in the market. Since the exchange began it has attracted low volumes, very few members and only offers short term contracts. It should be noted that it is in the forward market where trading is at its thinnest, a market the N2EX does not yet cater for. It is also highly possible that the establishment of a competing power exchange will just lead to the fragmentation of the small amount of trading we have now rather than consolidate trading activity and liquidity.

Discussions we have had with small suppliers suggested that using N2EX as a reference price for financial products did not appeal to them. Some suggested that this would bring suppliers under parallel financial regulation by the FSA. The sentiment was that small suppliers had a preference for physical products. Furthermore, there is a real risk that forcing trading on to a single platform, like the N2EX, could lead to a drastic increase in the collateral requirements of smaller parties, the costs of which could be passed on to customers. This is important as initiatives must meet the needs of small and independent market participants.

Some combination of Ofgem's policy proposals are likely to be required to increase liquidity and improve market signals in our view which is another reason for advancing the timetable.



CHAPTER: Three

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

A combination of two policy options is advisable to meet separate (although complementary) objectives. These are the implementation of (see below for details):

1. a self supply restriction (or a Forward Market Obligation) to improve the overall level of liquidity and price formation process
2. a regulated market maker or mandatory auctions (for forward products) to provide the trading requirements of independent suppliers and generators with the ultimate aim of increasing the contestability of the market. As an additional bonus we hope it will allow large I&C buyers to access the market directly to procure their power needs (if they wish)

We think that Ofgem should investigate the cash out arrangements separately if it has sufficient resources. However, if Ofgem feels the need to prioritise, it should concentrate on measures to improve liquidity. Liquid wholesale markets are the precursor to efficient cash out prices and long term forward contracts (please see our response to Project Discovery for more details). Without this there will be an excessive incentive to vertically integrate, too much of which can work against the interests of consumers by squeezing liquidity and therefore reducing competition.

We think that Ofgem should also monitor the ability for the demand side (large I&C customers) to participate in the wholesale market. Large energy users are potentially a major driver of liquidity. As such Ofgem should investigate whether these users have the ability to access their energy requirements directly from the wholesale market if they wish to rather than accessing their requirements through a supply company. We are aware that there may need to be amendments to current market rules to cater for this (for example relating to the settlement of energy for sites).

CHAPTER: Four

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

We do not believe this is an appropriate remedy. The obligation would have to be very carefully designed to ensure that it both improves the contestability of market and improves the price discovery process. We don't think it would contribute effectively to the price formation process (therefore increasing confidence in traded prices) especially if contracts between parties are made bilaterally on the 'off market'. A large proportion of longer dated trades are currently made in this way which is the principle cause of the low level of liquidity. The obligation would have to proscribe that trading occurs on an OTC intermediated market or power exchange which we think would be overly bureaucratic.

This approach would also be harder to monitor than either an auction or market maker based approach, because trading could occur privately rather than publicly. The absence of public scrutiny would leave all stakeholders dependent on Ofgem to monitor and report on the market more actively and intrusively in comparison with other policy options.

However, it is our understanding that some smaller suppliers believe this policy option could go some way to helping them obtain the power they need to meet their customers' power requirements. It is our view that this option should only be progressed as a last resort in the event that all over policy options have failed to meet the needs of smaller market participants.

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

If Ofgem decided to go ahead with this option, we would want a remedy which rectifies the contestability of the market for both independent suppliers and generators. Therefore such a measure should be placed on large generators and large buyers over a certain production/consumption level, in effect the 'Big Six' and a few large independent generators.

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

It would be very important for Ofgem to provide detailed and clear guidelines so as to ensure that the principles behind the obligation were met and adhered to (such as non-discriminatory access etc.). It would also need to actively monitor and report on compliance.

The products made available must meet the needs of independent players in terms of clip size, duration of contract, shape subject to the costs of providing them. Special consideration should be given to products of longer maturity dates. Contracts that are sold must not be price indexed to the illiquid forward market but must be actually sold on either an OTC (via brokers) or exchange platform to allow price transparency and liquidity to develop.

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

Yes (see above). It is imperative as this represents source liquidity which is vital in boosting re-trading (churn).

Question 5: What costs would this option impose?

Regardless of the costs of this measure, we are of the view that this option will not sufficiently meet the objectives set out above. However, if Ofgem is minded to proceed with this policy option it must produce a full impact assessment of this measure.

CHAPTER: Five

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?

If this option is progressed further we believe that its primary objective should be to improve the contestability of the market. A market making solution could provide benefits to smaller participants in terms of having a lower credit rating than small suppliers. This could mean that smaller market participants would be able to access their power requirements at lower cost than at present although of course a balance needs to be struck in terms of lower collateral requirements and ensuring that trading parties are adequately protected from counterparty risk. There are also benefits which could flow from the increased transparency the market maker could bring in terms of reporting price signals to the wider market and allowing Ofgem to measure the success of the policy option. It must be noted that the improvement in liquidity following other measures could make this a temporary measure as we would hope that voluntary market makers will trade more proactively (BarCap, Aron etc).

The market maker remedy must be used in conjunction with a measure targeted to improve overall liquidity and price transparency (see below).

It is also very important that the market maker is designed so as to mitigate against the possibility of gaming by the companies who will be asked to 'guarantee' the power volumes.

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

It is important that the products which are made available through the market maker meet the needs of independent players in terms of clip size, duration of contract, shape subject to the cost of providing them. Special consideration should be given to longer-dated forward contracts.

Question 3: What volume obligation would be appropriate?

We would prefer a volume obligation which meets the needs of independent and smaller market participants rather than a volume requirement which is intended to improve the overall level of liquidity in the market. As such this measure would need a lower volume requirement to meet the needs of smaller market participants in comparison with the volumes required to meet the needs of the whole market. It is more important that the relevant shapes and maturities of contract are available to market participants. We believe a separate measure (detailed below) will be able to achieve the objective of increasing overall liquidity.

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

There is a danger that the implementation of a regulatory market maker could deter voluntary market makers from actively participating in the market of their own accord (see above). This risk can be mitigated by introducing measures to improve overall levels of liquidity (thus attracting market makers). Furthermore, establishing a market maker which is independent of the 'Big Six' should help ensure that the market making agent functions for the benefit of smaller players. Once the overall level of liquidity improves there could be an option to disestablish the regulated market maker subject to consultation.

Question 5: What costs would this option impose?

In every case, costs must not be viewed in isolation from the benefits a measure will provide. As such it is essential that Ofgem undertakes thorough impact assessments on all the proposed remedies.

CHAPTER: Six

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

Auctions could help kick start liquidity initially but there are many other challenges involved in ensuring they meet their required objective and that they are not 'gamed'. If this was to be implemented we believe that it should be targeted on improving the contestability of the market. We're also unsure as to how this will benefit independent generators as the small suppliers in total only account for a very small percentage of the GB electricity supply market. We are not sure that this volume requirement would be enough to satisfy the needs of independent generators.

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

The volume requirement should be tailored to meet the needs of independent and small market participants rather than the larger volume requirements that would be needed to boost the overall level of liquidity in the wholesale power market.

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

Large generators above a certain production level should be obliged to offer into the auction. The prohibition of selling between vertically integrated companies will also have to be enforced.

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

It is important that companies obliged to sell into the auction provide products which are useful to smaller market participants (in terms of clip size, duration of contract, shape etc) subject to cost.

If the auction process were to be implemented along the lines of the Virtual Power Plants (VPPs) established in continental Europe, we would prefer to see the implementation of physical rather than financial VPPs ie electricity bought from the VPP can be subsequently resold in the wholesale market – it is not an insurance contract. As such a physical VPP is more likely to drive increased liquidity and churn. In any case regulatory monitoring of the auction process will be crucial to ensure that downstream affiliates of the VPP are prevented from repurchasing power which is intended for small retail competitors.

The French energy regulator the Commission De Regulation De L'Energie (CRE) published a summary of the consultation responses which detailed the experience of VPPs in the French electricity market[7].

The majority of respondents stated that the introduction of the VPP was a major contributor to the development of competition on the wholesale and retail markets. The VPP achieved this by increasing the volumes offered on the futures markets, allowing new entrants to purchase their power requirements and therefore compete in the retail market. The VPP also increased the level of liquidity in the wholesale market by facilitating the emergence of robust price signals. Furthermore, the majority of respondents considered that the VPP products are more attractive than the products generally available on the OTC and other markets.

However, consumers and some other market participants considered that the VPP did not make any contribution to increasing competition in the market. This is because the prices for VPP products were aligned to market prices and as such were not an attractive alternative to products available on the wholesale market. Furthermore, it was claimed that the products and contractual framework were not adapted to meet the needs of eligible participants and that the process is complex, restrictive and opaque leading to significant transaction costs. It was also claimed that the 'curve of indifference' implemented by EDF to interlink the prices of various products would tend to increase the attractiveness of the short-term products at the expense of long term products. These long term products were generally higher priced than those sold on the wholesale market. Finally, there was support for the VPP to provide separate short and long-term products and that the long term products should be sold at longer term (up to 10 or 15 years).

It seems that while most market participants felt that the introduction of the VPP in the French electricity market had some beneficial effects it was not tailored adequately to the needs of some market participants. When Ofgem further develop this proposed option it would be helpful if it learns from the experience of French electricity market as well as other foreign markets.

[7] **http://bit.ly/ckLzzX**

Question 5: Should the mandatory auction apply to day-ahead volumes and/or to longer dated forward products?

Auctions should apply to forward products not just day-ahead. It is in the forward market where trading is at its thinnest ie where the major problem exists. By just implementing a day-ahead auction we would risk duplicating one of the market initiatives, the N2EX, which presumably (and by definition according to Ofgem's proposed approach) would have failed to provide the required improvements in liquidity. Furthermore it seems clear to us that this type of measure provides little confidence to the small and independent market participants. The method of establishing a robust reference price and linking these to financial derivatives contracts (which is common place in the Nordpool market) seems a fairly alien concept for many market participants in GB. Trying to impose a particular trading model on market participants who are familiar with OTC intermediated markets seems an inefficient way to increase liquidity. We believe that liquidity can be increased by going with the grain of current trading methods (physical OTC as long as contracts are executed via a broker and/or on an exchange).

Question 6: What costs would this option impose?

In every case, costs must not be viewed in isolation from the benefits a measure will provide. As such it is essential that Ofgem undertake thorough impact assessments on all the proposed remedies.

CHAPTER: Seven

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

We believe this measure, in some form, would be the most appropriate solution to improve overall liquidity and the price discovery process. There are two ways this option could be implemented.

1. An obligation on large suppliers (the 'Big Six') to buy at least a proportion of their power on a forward basis on the wholesale market (OTC via broker or on an exchange)
2. Alternatively place the obligation on large generators (the 'Big Six' and a couple of others) to sell at least a proportion of their power on a forward basis on the wholesale market (OTC or exchange)

We would have a slight preference for implementing the first approach as there will be a greater number of eligible sellers (as well as a greater volume of power) able to meet the energy requirements of the six major suppliers. Also, this regulation would affect less firms and as such would be less intrusive.

In an ideal world it would be good if 100 per cent of traded volumes were executed on the wholesale market. However, this may be unachievable at present, so requiring a large supplier/generator to trade a proportion of their power requirements/surplus (between 40-20 per cent) would probably suffice.

Both of these options would need to be properly monitored to ensure compliance (see above). We don't envisage that this measure will improve contestability of the market materially for the smallest market participants in the very short run although we hope and expect it will in the medium-long run. This is because the market, at least initially, is unlikely to provide the bespoke products that smaller market participants need to operate effectively in the market. For that reason we propose the market maker or mandatory auction solution should be used in conjunction with this measure to improve contestability of the market.

While this will not guarantee that liquidity will improve dramatically (certainly in the short run) as it does not force secondary trading, it is important to note that there can be no secondary trading without the initial source liquidity (posted bids and offers). While it would be optimal to prohibit generators from selling their power volumes to downstream affiliates 'off-market' (or suppliers buying from upstream affiliates 'off-market'), there could be greater difficulty in enforcing this. However, requiring vertically integrated companies to trade among themselves via a wholesale market would still represent an improvement on current practise. Even if this results in the arms of vertically integrated companies trading between themselves this will still increase price transparency of power volumes which were previously traded internally away from the 'market's eyes'. This would improve the price discovery process providing the 'source' liquidity the market so badly needs.

As highlighted previously, we favour coupling this intervention with either a regulated market maker or mandatory auctions. Provided the design of that tied remedy allowed smaller players to participate in the market on reasonable terms it need not be a problem if the majority of traded volumes continue to be attributable to the 'Big Six'.

We could therefore refer to the self-supply restriction rather as a Forward Market Supply Obligation.

We don't believe that the previous problems with the self supply restriction are directly applicable to this measure. The old self supply licence condition was related to the supply of in-area customers. As such this aspect does not concern us here.

An alternative solution could involve imposing an obligation on the vertically integrated companies to post volume and price data of their internal trades on a central trade repository (similar to the trade repositories discussed in the European Commission document on derivatives markets[8]). The names of each participant could be made anonymous to allow external publication. This would allow other market participants and commentators to evaluate the validity of particular trades or trading patterns and ensure that internal prices reflect underlying market prices. This could provide confidence to the market and ultimately consumers that they are paying a fair price for their electricity.

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

Either all large generators over a certain production level or the 'Big Six' energy suppliers depending on which approach is taken.

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

It is our view that the self-supply restriction should be designed so that it minimises complexity. This should help ensure that when it comes to be monitored and enforced the task for Ofgem should be as simple as possible.

As such we don't believe that it should discriminate between different customers as this could add unnecessary complexity. However, as the large energy suppliers have fairly 'sticky' retail customer bases this could mean that large suppliers are in a better position to source the forward supply for these customers directly from the wholesale market.

Ofgem should investigate the costs/benefits of prohibiting the self sale and purchase, of at least a proportion, of the large vertically integrated companies' power trading requirements.

[8] Ensuring efficient, safe and sound derivatives markets: Future policy options, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank (20 October 2009) p7-8

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?

Yes, either a mandatory auction or a market maker. See above.

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

We don't believe that the previous problems are directly comparable (see above). We also hope that the EU Third Package which contains new information gathering powers for National Regulatory Authorities (such as Article 40) will help Ofgem monitor compliance. Our information gathering template which we have shared with Ofgem or some other tool could also be useful in monitoring wholesale market trading as well as bilaterally structured 'off-market' contracts.

Ofgem should ensure that data is provided to it by exchanges and brokerages so they are able to examine the extent to which trading involves companies self supplying one another. The use of central trade repositories could be of further use to Ofgem in monitoring a Forward Market Supply Obligation.

A good example of regulatory market monitoring practice which Ofgem could learn from is the market monitoring undertaken by the French energy regulator the Commission De Regulation De L'Energie (CRE).

The CRE has a duty to monitor French wholesale energy markets and has the power to request data from wholesale market participants. For their data on gas trading on intermediated and non-intermediated markets, the CRE gathered data from the energy brokers (for OTC trading) and from Powernext (exchange trading). However, the CRE were unable to get bi-lateral trading data. The CRE aggregated the volume of gas trades undertaken in the intermediated and exchange markets and calculated what proportion this was in relation to total domestic gas consumption[9].

It could, however, be quite difficult to assess the level of trading on non-intermediated markets in this inverse way if the churn ratio for intermediated products is greater than total physical consumption ie a churn ration of more than one. The best way to find out an accurate level of total trading is to gain access to all energy trading information. This is where we hope the EU legislation could be useful to Ofgem.

Furthermore, the CRE publish regular wholesale electricity market data[10] (the CRE also publish regular wholesale gas market data) including the following:

- Annual volumes traded by product (weekly, monthly, quarterly and annual) on the French intermediated wholesale electricity market
- Intraday transactions and volumes traded on the intermediated OTC market and EPEX Spot
- Day ahead transactions and volumes traded on the intermediated OTC market and EPEX Spot
- Monthly (month + 1-3) transactions and volumes traded on the intermediated OTC market and EPD France
- Quarterly (Q1-4) transactions and volumes traded on the intermediated OTC market and EPD France

[9] French wholesale electricity and natural-gas markets in 2007 – Monitoring Report, Commission De Regulation De L'Energie (January 2009) p115-116.
[10] **http://bit.ly/b9JZLV**

- Annual (Y+ 1-3) transactions and volumes traded on the intermediated OTC market and EPD France

Question 6: What costs would this option impose?

In every case, costs must not be viewed in isolation from the benefits a measure will provide. As such it is essential that Ofgem undertake thorough impact assessments on all the proposed remedies.

CHAPTER: Eight

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

Collateral requirements

Credit and collateral requirements is still a big issue for small energy suppliers. It is our understanding that small suppliers believe that tackling liquidity in isolation won't be enough to increase the contestability of the market. We have been told that volumes contracted on GTMAs require credit up front for all volumes, including those not yet delivered and that small suppliers can act as a distressed buyer and as such are then subject to, often penal, cash out imbalance prices.

However, it is very difficult to see changes, be it smearing costs or others, sitting comfortably with the current market arrangements. We hope that enhanced OTC cleared and/or exchanged cleared platforms will help here. In any case, Ofgem should look to engage with small suppliers to help find a solution to the problems they face surrounding collateral requirements.

Nevertheless, we are of the view that improving the main barrier to entry in the power market (a lack of liquidity) should be the main focus for Ofgem. This represents a far less intrusive response to improving the contestability of the market.

Finally, some small suppliers suggested to us that the traditional EFA blocks (ie 'peak', 'off-peak') are the wrong shape as well as unavailable. Ofgem should follow this point up further with smaller suppliers bilaterally.

EU communication on derivatives markets

We would like to see a greater proportion of power traded on intermediated (via a broker such as Tullet Prebon) OTC markets (potentially with trade repositories) or on centrally cleared exchange platforms rather than on bilateral structured market contracts ('under the counter'). However, it may not be proportionate to move all energy trading to the intermediated OTC market or exchange platform (in terms of the costs this could impose on market participants which could risk increasing costs to consumers). There can be some efficiency benefits for vertically integrated companies in entering into structured off market contracts which can benefit consumers if there is sufficient competition in the market.

It is our view that the market can still function adequately if a certain proportion of trading remains off market as long as this proportion is not too great (we hope the measures designed to kick start liquidity detailed above will begin a virtuous circle – liquidity begets liquidity!). Furthermore, it is our view that OTC trading executed by a broker (Tullet Prebon, for example) on industry standard template contracts (in the case of power GTMAs) provides adequate price transparency through the operation of price reporting organisations (ICIS Heren, for example).

We must be careful not to increase the collateral requirements of energy trading even further than they are at present as collateral issues represent a major barrier to entry/organic growth for small supplies. Collateral requirements beyond four seasons on an exchange can be very expensive for independent players. Policy needs to be centred on providing the lowest cost solution which maximises the benefits for consumers.

It is important to remember that the Commission 'does does not want to limit the economic terms of derivative contracts, neither to prohibit the use of customised contracts nor to make them excessively costly for non-financial institutions'[11]. Further, the G20 agrees that 'all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms *where appropriate*'[12].

CHAPTER: Nine

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

We agree that the high level assessment criteria correctly identifies the objectives the proposed options must fulfil to warrant implementation.

We would order the objects in the following scale of importance (1 most important, 4 least important):

1. Improving overall liquidity in the wholesale electricity market, including liquidity along the forward curve (in fact we would say especially)
2. Improving the ability of small/independent suppliers to meet their wholesale energy purchasing and risk management needs and thereby to sustain and improve supply market contestability
3. Other benefits, including improving the ability of large consumers and independent generators to access appropriate wholesale liquidity and thereby improve market investment and efficiency
4. Least cost and disruption to efficient market outcomes and minimising unintended consequences (obviously the package with the greatest net benefit should be implemented)

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

We would like a combination of two measures to meet two separate overriding objectives, the implementation of:

1. a self supply restriction (or a Forward Market Obligation) to improve the overall level of liquidity and price formation process.
2. a regulated market maker or mandatory auctions (for forward products) to provide the trading requirements of independent suppliers and generators with the ultimate aim of increasing the contestability of the market. As an additional bonus we hope it will allow large I&C buyers to access the market directly to procure their power needs (if they wish)

We have no preference at this stage between the market-maker and mandatory auction models – either approach is potentially workable, depending on detail. Ofgem should further consider the pros and cons of both approaches as well as further develop the four policy options (self supply restriction, mandatory auctions, market maker and to a lesser extent the direct trading obligation).

[11] **http://bit.ly/9tGMYI** (p3)
[12] Ibid. (p8)

Below we have issued a few initial problems/issues to be analysed by Ofgem:

Issues for a regulated market maker	**Issues for mandatory auctions**
Could a regulated market maker deter entry by voluntary market makers?	Is there a high chance of gaming?
Could a regulated market maker be difficult to disestablish if/once overall liquidity improves (and thus load additional costs on consumers)?	Are there insurmountable informational advantages for vertically integrated market participants?
Would it be better to incentivise voluntary market makers (for example offering discount membership on exchanges) rather than create a mandatory one?	Would there be higher costs in developing an auction of forward rather than just day ahead products? Would these outweigh potential benefits?
If volumes must be provided by the 'Big Six' to reduce the risk to the market maker is there a material difference between a market maker and a mandatory auction?	Would it take longer to set up than a regulated market maker?
Would it take longer to set up than an auction system?	

Consumer Focus
Campaigning for a fair deal

Response to Ofgem's consultation on Liquidity Proposals for the GB wholesale electricity market

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