cornwallenergy

19 April 2010

Andrew MacFaul
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Ofgem
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Dear Andy,

Re: Liquidity Proposals for the GB Wholesale Electricity Market

This is a response from Cornwall Energy to the *Liquidity Proposals for the GB Wholesale Electricity Market* consultation. We have discussed its contents with the small and independent companies that are members of our Energy Suppliers Forum[1], and the arguments set out here are supported by many of the individual members. But this letter does not represent a view from smaller suppliers. Most members will be submitting their own responses and we understand some of them have engaged directly with you to confirm the fundamental importance of this issue to them.

Support for Ofgem's work

Cornwall Energy warmly welcomes the work the regulator is undertaking to understand the issue and improve wholesale electricity market liquidity, but with two qualifications. These qualifications are related to what we believe is the core of the work—and why Ofgem scrutinised wholesale trading in the first place—namely that malfunctioning wholesale energy markets might be inhibiting the supply market and preventing consumers from gaining the full benefits of retail competition.

The first qualification is that the key issue is about basic availability of product so independent retailers can compete with the Big Six. This product must be of appropriate durations and size and shape. Ofgem's concern should not be about the much more demanding task of creating deep liquidity as an end in itself. The basic

[1] The Energy Supplier Forum is a Cornwall Energy hosted monthly meeting that brings together many of the smaller energy retailers in the market to discuss pertinent regulation and policy issues. More information here: http://www.es-net.org.uk/

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regulatory focus should be access to *physical product and shape* by non-Big Six suppliers. There are other issues surrounding increasing market liquidity and the number of participants, introducing intermediaries and stimulating financial risk management. But, while these issues dominate Ofgem's consultation, these are not as immediate and can be progressed over longer time-scales. Consequently the key issues about smaller participant access needs to be given precedence. Ofgem's suggested success criteria to measure improvements in liquidity, which have been promised for publication by summer, should give priority to availability of products suitable for smaller suppliers and new entrants. If Ofgem also made clear by what time it wanted to see clear signs of improvement it may help concentrate minds, or at least put a marker down for when further intervention may be necessary.

The second concerns the pace at which Ofgem is progressing this workstream. The defects in the electricity market are now widely acknowledged. It is now almost two years since Ofgem told the select committee about its concerns over liquidity, and the committee itself endorsed these in a high-profile report. Most recently the Government's energy market assessment asserted again that the current arrangements are distorting competition and deterring new entry and that low wholesale market liquidity is the primary barrier. It has taken Ofgem twice as long as it indicated last summer to produce this second document, and it could take twice as long again before tangible measures are implemented. As a result we believe the timetable for reaching decisions and implementing them should be expedited.

Market response has been inadequate

Ofgem should not wait and see if the market will deliver a response, via exchanges, to materially improve overall market liquidity simply because industry initiatives are addressing different aspects of the problem. The N2EX exchange may play a part in improving market liquidity, but it will not improve short-term access to wholesale product that will help smaller suppliers compete and bring benefits to consumers. The current time of low wholesale prices and sticky standard retail prices may well have passed by the time the N2EX initiative is fully established. Independent suppliers, the one agent that could have brought to consumers the benefits from low wholesale prices, will have been in effect precluded from doing so.

This is not to say that most of the smaller suppliers are not keen to see the N2EX project succeed; rather they do not see it as a panacea, and it certainly will not be a "quick fix". Indeed the current low volume of trades on N2EX and other trading platforms—all traded at the prompt end of the curve—does not enable independent parties to access products of the right shape and size out to at least a year. Hence they are not able to hedge effectively risk from acquiring new small and medium customers in the supply market who are typically on rolling or one and two-year contracts. Therefore they are much less able to compete with large players for customers. While several smaller players have said they might have recourse to N2EX, the facility to do this would have marginal benefit if they cannot also access longer-term product and the necessary shape.

There is a "chicken and egg situation" with the ambition of N2EX to create longer-term products, as this can only be achieved once liquidity on the prompt has improved substantially. Should this develop rapidly, it may lead to the creation of more financial derivates for trading purposes. Generally speaking, though, financial derivatives are not attractive to all players as they involve increased costs to comply with Financial Services Authority regulations. Again such progress—even if it can be realised—would not address access to small quantities of physical product and shape.

More fundamentally the industry should not be relied upon to deliver reform and address the distortions. It has taken five years for N2EX to be launched and current trading levels remain negligible. Further it is two years since the select committee hearings and almost a year since Ofgem launched its initial thoughts on wholesale market liquidity. Over this period there has been no discernible change in the commercial approaches of the Big Six with regard to providing product. Indeed credit concerns have exacerbated with the recession, and we have heard from a number of smaller suppliers that available counter-parties have continued to decline. If Ofgem had hoped its liquidity consultations might hold out the prospect of a "cure period", any such expectations have proved without foundation. The focus of attention of the Big Six remains trying to convince Ofgem there is no problem, rather than on providing options and product to smaller counter-parties thereby providing evidence that they are committed to addressing the distortions.

Preferred remedies

Of the proposed remedies put forward, an obligation on the Big Six to offer products to all parties on a non-discriminatory basis, on similar terms as a company offers them to its own supply business, is the most appropriate.

Such products should be defined after careful discussion with smaller participants on what they need (small annual strips and peak; not multiple MWs of monthly or seasonal power). There could be an orderly process for establishing this continuous offering, through a managed platform, though it is not correct to characterise this as a market maker. There are several offer structures from the medium and larger user retail market already offered by the Big Six that might be appropriate. For example:

- flexible contracts allow consumers to nominate tranches of power they wish to purchase at or near published forward curve rates. These contracts can run for periods of several years and would define elements of load that are baseload, peakload and residual with formulas for setting rates for each element in the event that no nominations are made by the consumer. These arrangements are already widely available for consumers with maximum demands above 10MW and, with some simplifications, even as low as 1MW. This range would cover the spectrum of established smaller suppliers; and
- formula-related or tracker contracts allow consumers with demands from 1MW to relate elements of their wholesale costs to curve rates via formulas that relate specifically to their load profiles. These arrangements tend to be of shorter duration than flexible contracts and would appear to be more suited to suppliers that are establishing themselves in the market.

Often arrangements of the kind are managed by third party intermediaries on behalf of end-user consumers in business. This practice is becoming particularly widespread in the public sector, for example, and might be readily replicated.

Admittedly forcing major players to offer arrangements like this to smaller rivals may mark a significant regulatory intervention. However it needs to be remembered that small suppliers who cannot access product (appropriate quantities and shape) even if they were able to undergo significant growth and new entrants looking to exploit new niche opportunities would only represent a small fraction of the total market. The fact that since the market was liberalised no new entrant has grown to a point at which competitive pressure is sufficient to challenge the Big Six is telling in itself.

Superficially non-discretionary, regular auctions by the Big Six could also stimulate liquidity and attract new suppliers and large customers to the market and could in the longer term lead to commercially-viable market-maker services and traded services to smaller players and new entrants. However this would represent a major structural change in the market that is not proportionate to the scale of the problem.

Similarly the self-supply restriction is probably not very practical and is likely to lead to the Big Six simply selling to themselves, and could well impose unnecessary costs on consumers.

Interactions with NETA need addressing

As we set out in our response to the earlier consultation[2], the current situation of illiquidity has arisen despite current electricity trading arrangements being premised on the development of healthy traded markets. Rules for residual uncontracted supplies under NETA were deliberately framed to incentivise parties to trade on the market. But in practice many independent players can not do so because of the basic illiquidity compounded by shape, timing and size issues. The designers of the trading arrangements failed to see that inherent volatility in commodity prices would lead those players that could to integrate in preference to contracting. Therefore, although the relationship between traded markets and the rules for uncontracted supplies were intended to boost competition, in practice it has been undermined. This is because participants who cannot access product are systematically exposed to energy imbalance prices designed to reflect short-term balancing costs onto them. These costs are frequently above traded market prices, sometimes excessively so, again meaning that parties who cannot contract or contract efficiently are at a significant competitive advantage.

[2] http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/Documents1/Cornwall%20Energy%20Response%20to%20discussion%20document.pdf

At a technical level important aspects of cash-out remain defective and will continue to be problematic irrespective of steps to stimulate liquidity. Urgent measures are needed to reduce cash-out complexity, energy imbalance price pollution and artificial restraints on trading imposed by the timing of gate closure. Although the outcomes of implementing P217 *Revised tagging process and calculation of cash-out prices* will be reviewed this November, early indications show that it has not materially helped narrow artificially wide spreads. Indeed initial evidence suggests it may have increased prices in many half-hours because of the disaggregation of BSAD.

The desirability of ex-post trading, especially between suppliers with matching imbalances, should be examined urgently.

Credit remains a significant problem

The issues for many smaller suppliers are also closely bound up with problems associated with current credit arrangements. Even if proposed solutions were put in place, until progress is made on finding a fair balance between ensuring smaller parties are able to provide proportionate levels of credit, there will remain real barriers to market access. Many larger players deem such players to be too risky or of insufficient scale to trade with. Very often credit is used tactically as a mechanism for incumbents not to trade with smaller players. This is not an easy issue, but each of the Big Six companies should treat the supplier as the intermediary no differently than if it were dealing with the end-consumer itself. Issues concerning multiple, overlapping credit within the industry also need to be addressed.

I have also enclosed an *Energy perspective* piece from the 223rd edition of our *Energy Spectrum* weekly newsletter as an annex to this response amplifying on some of these themes. I am happy to discuss these issues further.

Yours sincerely,

Nigel Cornwall

Shaken not shaken, as Ofgem mixes liquidity cocktail

Ofgem has at last issued its follow-up document to last June's review of wholesale energy market liquidity. In it is has set out how it intends to address low levels of liquidity in the electricity wholesale market. That is unless the industry can itself deliver decisive action in a period of grace the regulator intends to allow it. In this *Energy perspective* we consider whether industry measures will be effective enough to render further action by the regulator unnecessary, and we also look at some of the pros and cons of the fall-back options it has set out.

Live and let die

While the June 2009 review gave the gas market a clean bill of health, it found serious problems in electricity. Liquidity was low in comparison with other British commodity and other European electricity markets. Trading had actually fallen significantly since a wave of upstream consolidation had commenced in the early part of the decade. As a result smaller participants and new entrants without vertical integration struggled to access wholesale product in the shapes and the durations they needed. Consequently Ofgem in its initial thoughts document considered at a high level a range of possible measures for increasing market liquidity.

Quantum of solace

Ofgem's 22 February follow-up, *Liquidity proposals for the GB wholesale electricity market*[1] consults in more detail on selected options to help players and the circumstances in which the regulator might deploy them. But its preferred route is for the industry itself to develop solutions. It therefore profiles recent and planned market initiatives including:

- the launch of the new N2EX electricity exchange;
- APX's intention to allow trading on its intra-day spot market up to 15 minutes before gate closure;
- the London Energy Brokers Association new month-ahead price index; and
- further developments "to be expected", arising for instance from auctions for BritNed interconnector capacity and from "market coupling" following other interconnection and integration with neighbouring markets.

Thunderball

But there could be much more radical intervention if the market fails to deliver. Possible measures include:

- an obligation on large generators to trade directly with small/independent suppliers. Ofgem thinks this could be relatively quick to implement and provide confidence to new entrants that they could source competitive wholesale product on a continuing basis. But it could also face enforcement challenges as the guidelines accompanying the licence condition would be difficult to define. Compliance monitoring may also be difficult;
- a requirement on the Big Six to provide product via a special agent or market maker. It would post firm prices for specified products on a trading platform. Ofgem said a high volume approach could improve overall market liquidity, create a robust market price and help promote price transparency. But there would be challenging design issues, and it could be less flexible than a direct trading obligation;
- mandatory power auctions that obliged large generators to offer a certain percentage of their output, either day-ahead auction or forward products. Experience in other countries showed that, if day-ahead volumes were substantial, credible reference prices could develop to support financial trading. But this option would have a substantial impact on current generator contractual commitments and could be initially disruptive; and
- self-supply restrictions that required the Big Six to buy from outside their own generation business. A fully-effective restriction might ensure that more volume reaches the market. This could increase overall liquidity if secondary trading increased as a result. But there were a wide range of design challenges to make such restrictions effective, and monitoring and enforcement costs could be material.

Living daylights

Ofgem has suggested a preliminary assessment of how the market develops in the summer of 2010, with a decision then on whether to develop its measures. It has proposed an initial set of assessment criteria: improving the ability of small/independent suppliers to meet their wholesale energy purchasing and risk management needs; improving overall liquidity along the forward curve; improving the ability of large consumers and independent generators to access appropriate wholesale liquidity; least cost and disruption to efficient market outcomes; and minimising unintended consequences. This stage will be followed by a further assessment towards the end of 2010, which will form the basis of a decision on whether interventions should be made.

This approach effectively provides the existing industry-based initiatives with a window to develop. Ofgem's intends to base its final decision from applying more specific (unfortunately as yet unquantified) criteria. They consist of: high volumes traded in standard products; availability of key longer-dated products and/or financial derivatives; use of trading platforms by small/independent suppliers; and positive feedback from smaller suppliers and potential entrants. But if Ofgem decides they are needed, its cocktail of measures would be set to become operational during next year.

Casino Royale

The consultation marks a big step forward. It unambiguously recognises severe trading distortions in the market. As important it concedes the pressing need to facilitate action to allow all participants to trade and manage their risks accordingly. (While these are our and not their words) it seems to accept that the success of the NETA bilateral trading model (whatever its other failings) is contingent on participants generally having routes to market on fair terms.

We would have preferred the regulator to cut to the chase now. It is very doubtful—if applied properly—the criteria that have been set out will be met in the timescales required. N2EX, which is a joint venture between NASDAQ and Nord Pool, opened on 12 January with three product areas, a continuous spot market, a prompt market and a day-ahead auction, and it also intends to develop a financial derivatives market. At the start of February the exchange said it had traded negligible amounts in the first three weeks. At that stage there were eight participants though 25 more were "in the pipeline." Daily auction volumes have been miniscule, at between around 2-11GWh per day, equivalent to 0.5% or so of generating capacity at baseload. And APX, the established exchange operator, said recently its spot power volumes had remained no more than "steady" in 2009 against 2008. Its new intra-day sport market opened very recently on 15 February, and a similar pattern of inactivity seems to be emerging here too. Indeed scant liquidity could be being fragmented as a result of these initiatives.

Of the other initiatives highlighted by Ofgem, none of the developments can have any impact on liquidity in the timescale that the regulator has allowed itself for decision-making. So real progress would require an immense and uncharacteristic effort by the Big Six (it has taken almost five years to get N2Ex off-the-ground). The prospects for organic improvement in other forms of trading through brokers and OTC are not strong either, judging by the latest annual survey of trading activity in the UK by the FSA that showed activity at a stand-still in the sector.

That said, further development work on the four options is needed. With wholesale prices expected to remain relatively benign and healthy supply in the wake of recession, the extra step is probably not crucial. A three to six month delay, while not ideal, is probably an acceptable cost ***if*** the right solution is to emerge. And perhaps a short delay will provide a window in which the large integrated suppliers can show whether they have an appetite to trade with a wider group of participants and that they are willing to help kick-start change. We would also like to see more work on mechanisms to support credit during this window. But we think direct regulatory intervention is now unavoidable.