

Response of EBICo Ltd to the Ofgem Consultation Paper:

Liquidity Proposals for the GB wholesale electricity market

Ebico is a not-for-profit company established specifically to help the fuel poor. We are different from all other energy suppliers in that our gas and electricity tariffs (EquiGas and EquiPower) are the same regardless of how the customer pays. Thus our direct debit customers pay the same price per unit of fuel as our PPM customers. We also have no standing charge and no tiered pricing: we charge the same price per unit of fuel whatever quantity of fuel the customer uses. This helps consumers who use low quantities of energy (often those on low incomes in very small dwellings).

Ebico has now been operating for eleven years. We have about 55,000 customers.

Our answers to the questions posed in the consultation paper are given below.

Chapter 1

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?

We agree. There is insufficient competition in the supply of gas and electricity to domestic customers and the current market is very inefficient. The six major suppliers are an oligopoly (without collusion). It is very difficult for other suppliers to compete effectively with these six because of the barriers to entry, not the least of which is poor electricity wholesale market liquidity.

The low levels of liquidity in the electricity wholesale market are, in our view, having the effect of stifling innovation which has a detrimental effect on customers on low incomes, as companies who would offer bespoke products and services to such a niche are prevented from entering the market.

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

We agree. The larger number of physical players in the wholesale gas market, resulting, originally, from the wider ownership of UKCS gas-producing assets and now the greater degree of international interconnection and gas trading, has meant that, although the Big-6 dominate the residential supply market, wholesale gas market liquidity has been a lesser problem. We believe that, historically, the lack of new entry to the residential gas market has been a function of the very small (and, occasionally, negative) margins available in this sector – themselves a function of the barriers to entry and vertical integration in the electricity market.

Chapter 2

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

In as far as they go, yes. We note that these are qualitative measures, as opposed to quantitative measures, but we accept that this is inevitable in a situation where Ofgem does not wish, in the first instance, to constrain how the market developed. However, an additional key measure of success would, we believe, be sustained transaction levels on a screen-based OTC electricity options platform.

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

For the reasons given above, no.

Question 3: When should market success be judged?

The London Energy Brokers Association (LEBA) first discussed a composite index in 2002. The Power Traders Forum (PTF) first discussed sponsoring a market service to encourage electricity market liquidity in 2004. It is clear to us that, contrary to Ofgem's hopes regarding market-developed solutions, left to their own devices market participants and intermediaries will be unable to resolve the chronic lack of market liquidity within any reasonable timescale. Notwithstanding our response to Question 1, we believe that, given the legacy of glacial progress on the issue of liquidity, there is a strong argument for Ofgem to act immediately.

Chapter 3

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

No, we don't believe so.

Chapter 4

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

No, we do not believe so. We believe that there are a number of key weaknesses with this approach which would render it both costly, in compliance terms, for the trading entity (costs which would be passed-on to the consumer) yet ineffective in achieving the success criteria specified in Chapter 2. Underlying all these weaknesses is the highly variable nature of perceptions of risk (price and credit), and their associated costs, across different corporate entities and individual circumstances. In the instance of price, for example, in agreeing a price with a counterparty the trader acting on behalf of the seller will seek to achieve a minimum premium over an internal reference price which

represents the seller's view of the risk posed by the counterparty and the price of that risk. That risk, and its price, will be derived from analysis carried out by the seller's Risk Management team and will vary from counterparty to counterparty and from time to time as inputs to the credit risk algorithm change continually. Ex-post, it will be practically impossible for any external audit of the seller's risk management process to establish whether or not the price derived, on one particular occasion and set of circumstances, was 'reasonable' in terms of the risk management process. Such an audit process would be costly to both prepare for and to carry out and would, in our view, invariably inconclusive.

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

See answer to Question 1

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

See answer to Question 1

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

See answer to Question 1

Question 5: What costs would this option impose?

See answer to Question 1

Chapter 5

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?

No, we do not believe that it is.

In many ways the proposal is similar to the establishment, by the Electricity Forwards Agreement Association (a predecessor to the current Power Trading Forum), of GNI as a mandated provider of telephone-based broking services of Electricity Forward Agreements (a type of CfD) in 1991. This was a successful initiative to develop the wholesale trading of these instruments. GNI's costs were underwritten by the EFA Association for its first 2 years of EFA broking. However, the key difference between that initiative and Ofgem's proposal for a market-maker is that liquidity in the, then, nascent EFA market was clearly in the interests of all the principals. It is not clear to us that, after 9 years of operation of the existing electricity wholesale market, greater liquidity in GTMA-based forward contracts is necessarily in the interest of the major physical players.

We believe that the market-maker proposal offers the major physical players very little in terms of commercial benefits yet would place administrative, operational and procedural

burdens on them. Given this balance of costs and benefits, we believe that it is unlikely that the considerable levels of commitment, innovation and co-operation that would be required of the Big-6 to overcome what Ofgem acknowledges are significant design challenges, would be forthcoming.

Ofgem correctly observe that, if the major physical players are required only to provide small volumes in small two-way clips to the market-maker, then, even if maximum bid-offer spreads are specified, knowing that the potential counter-parties will primarily want to buy would likely permit two-way prices to be set in such a way as to represent a premium over the wider market. The market-maker's prices would, thus, become a 'ghetto' for small retailers who would otherwise be unable to participate in the 'regular' market. The market-maker's services would, then, fall into disuse. Meanwhile, insistence on larger volumes to back the market-maker market would likely be rejected on the grounds that it represented a requirement to take excessive commercial risk.

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

See answer to Question 1

Question 3: What volume obligation would be appropriate?

See answer to Question 1

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

See answer to Question 1

Question 5: What costs would this option impose?

See answer to Question 1

Chapter 6

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

Yes. Absent significantly greater physical interconnection between the GB market and continental European electricity markets, we believe that a mandatory uniform clearing price auction represent the only viable route to greater market liquidity.

In order to be practical, we believe that it is vital that the measures that Ofgem seek to put into place to increase wholesale electricity market liquidity offer, in addition, commercial advantages to the major physical players. The settlement of very large bilateral physical contracts, even with netting, involves the flow of large amounts of cash and exposes all participants to very considerable settlement risk. We believe that a mandatory day-ahead uniform clearing price auctions covering each of the 48 half-hours, in reasonable volume, would establish a credible market clearing price for each half-hour. A market cleared price, which was based upon reasonable physical depth and half-hour granularity, would

enable the development of a market for swaps and CfDs based upon this cleared price. We believe that, very quickly, the cashflow and settlement risk advantages of trading CfDs, as opposed to physical contracts, would prompt the development of a market in these financial derivatives amongst the major players. Settlement risk would be constrained to the day-ahead electricity flows only. Indeed, if the entity conducting the auction process were entitled to smear the cost of delivery/payment failure across all auction participants pro rata to their total volume, then settlement risk would be mitigated still further.

For the small supplier, guaranteed access to an auction would have considerable advantages in terms of securing access to volume. In addition, with the market clearing price established, non-physical risk intermediaries would be able to offer more tailored risk management products to small suppliers which could be suited to their individual requirements and, thus, conducive to new entrants in supply.

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

We believe that all Grid connected, non-exempt plant which is registered as available in the each BMU weekly reporting process should be required to offer a minimum of 20% of available capacity into the auction process. Our view is based upon the need to balance the requirement for the auction to be sufficiently deep so as to avoid it becoming marginalised and be a reasonable base for a derivative market, whilst at the same time not requiring a fundamental change to the BETTA design.

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

All Grid connected, non-exempt plant should be required to offer into the auction as part of their Generation licence. This would not, of course, prevent any plant owner who did not wish to use the auction as a route to market from offering-in at a prohibitively high price. Whilst open to all supply companies, we also believe that, for an initial period, those supply companies with a group aggregate demand of 1.5 TWh p.a. should be obliged to register a minimum portion of their half-hourly day-ahead demand with the auction for filling.

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

The auction should

- be operated by a not-for-profit entity established for that sole purpose and with a mandate to encourage liquidity.
- close at noon on the business day ahead to enable follow-on bilateral spot trading (i.e. 3 auctions on Fridays other than bank holidays).
- operate on a uniform clearing price basis (i.e. with the price of the marginal unit of generation called to fill bids setting the price for all units).

- on closure, filled orders are converted to GTMAs with the auction operator as central counterparty and ECVNA and notified to the System Operator.
- operational risk is born by the auction operator whilst settlement risk exposure is smeared to all parties with filled orders pro rata to their filled volume.

In addition, for an initial period, to ensure the depth of the auction, the portion of day-ahead demand that obligated supply companies would be required to register for filling with the auction, as a minimum, should be set seasonally in such a way as to seek to ensure that it represented 60%-70% of offered generation. This would ensure major supplier exposure to the auction which would prevent its marginalisation whilst providing headroom in the auction for the growth of new supply participants and recognizing that some plant will effectively be opted-out of the auction through prohibitive pricing.

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

See answer to Question 1

Question 6: What costs would this option impose?

There would be costs in setting up the not-for-profit entity, the auction process and the ECVNA service. This bundle of services should be specified and tender bids invited.

For incumbent generators and suppliers, there would be costs associated with the resulting changes to physical and contract portfolio management. However, the maintenance of the BETTA design and the conversion of successful auction bids and offers to a single GTMA for each entity will minimise additional costs to participants

Chapter 7

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

No, we do not believe so. Essentially we believe that such a measure would be impractical to monitor and enforce. Big-6 contract portfolios are extensive, wide-ranging and complicated, involving cross-commodity and time spreads, bespoke option structures in addition to plain-vanilla physical trading. Any decision, ex-post, as to whether or not self-supply restrictions had been complied with or not would be almost impossible to make if it were based upon a list of contracts without being privy to the trading strategy that gave rise to that trading activity. In short, this measure would be relatively easy to frustrate for any trading body with a large contract portfolio.

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

See answer to Question 1

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

See answer to Question 1

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?

See answer to Question 1

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

See answer to Question 1

Question 6: What costs would this option impose?

See answer to Question 1

Chapter 8

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

We believe that the difficulties that new entrants experience with counterparty credit security requirements is due to the lack of competition in the provision of risk management products. We believe that the development of a financially settled derivative contract would result in the traded electricity market becoming considerably more attractive for non-physical risk intermediaries whose entry to the market would result in greater competition and innovation in dealing with credit risk and, thus, lower costs.

Chapter 9

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

Yes.

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

The mandatory day-ahead auction.