Liquidity Proposals for the GB wholesale electricity market – Response to questions from Elkraft AS

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 UK electricity market has has gone from bad to worse during the last few years, and we have more or less no hope in the market being able to resolve the situation by itself. The big 6 suppliers have shown few initiatives in doing so before, and we have little reason to believe that the situation will improve in the future. The situation has caused problems for both independent producers and suppliers, as insecurity about future prices is very high.

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

Yes, the gas market has shown an ok level of liquidity, and it is the electricity marketthat most critically needs new investment, and increased competition.

CHAPTER TWO

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

Yes, we are very happy to see that, at last, Ofgem releases some concrete criteria, which have been lacking up until now. We think the outlined critera are appropriate, but we would have liked to see better quantified criteria.

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

First target: 10 % of overall produced volume traded in an open, accessible and transparent way, preferably through one or more exchanges, through a day-ahead auction.

Second target: Availability of baseload forward/futures contracts on 50 % of working days for standard products, like the next quarter and the next year, in small clip sizes (1 MW) and to all players at terms comparable to the ones given by major commodity exchanges, like LIFFE, CME or ICE. We are especially thinking about the terms for collateral requirements.

Question 3: When should market success be judged?

We think policies should be implemented in August if the first target above (in the answer to question 2) is not reached by the end of July. For the second target, we think that the market should be given until the end of the year before any action is taken.

CHAPTER THREE

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

No.

CHAPTER FOUR

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

We think an exchange based mechanism is the best solution, but we think it could be a good idea to implement a direct obligation now, before trading through exchanges pick up.

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

All producers with a total installed production capacity exceeding 1000 MW.

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

The only publicly available reference price that we can think of are the retail prices of the big 6. Hence, we think that some average of all the big 6's retail prices should be used as a basis.

Regarding products, access to short-term volume is critical for a small supplier, because of the balancing problem.

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

Yes, generators should not be treated differently from suppliers. However, the needs of generators are different from suppliers in the way that they need longer dated products.

Question 5: What costs would this option impose?

It might be costly to monitor for the authorities, and the large companies will probably spend a lot of energy on avoiding being monitored.

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?

Yes, it is not a bad solution, but we think it should be imposed only after a day-ahead auction, providing a reliable reference price, has been established.

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

We think it would be appropriate to start off with a few products, in order to not make things to complicated.. For example, the nearest three months, the nearest two quarters, and the nearest year. If this is succesful, the market should be given some time to become liquid, and then obligations should be imposed on more products if needed.

Question 3: What volume obligation would be appropriate?

If there is an obligation to always offer a firm bid-offer spread, no volume obligation is required. However, the particiapants should be allowed to "pull out" of the market if their position reaches a specified ceiling, in order to protect themselves from loosing a lot of money, in a situation where for example other participants are better informed than the market makers. This could be specified as the market makers total accumulated loss pr. period.

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

Not sure about this. We think it might not be sustainable if the big companies are not participating themselves, from the start.

Question 5: What costs would this option impose?

It would in our opinion be a relatively cheap solution, if the big six are obliged to participate. They will surely complain if they become obliged to provide bids/offers, but we do not see why it should impose a lot of costs on them. Their biggest problem will be that they will have to adjust more to the signals of the market, instead of the market having to adjust to them, as it is now. Fees on the exchange will become a very small percentage of the overall cost of these companies. Collateral costs will neither be a problem for the big six, since they presumably will be short and long about the same volumes, since they are already quite "balanced", with production volumes matching sales volumes to a high degree.

CHAPTER 6

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

Yes, we think it is inevitable in order to get a working long-term solution. This will make the current balancing problem for small participants smaller as well, with volumes being available for short-term delivery (In the case of a day-ahead auction).

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

It is hard to tell. The obligation needs to include a substantial percentage of the big producers output to be effective. We suggest 10 % of total produced volumes as a minimum. This must include special arrangements, like tolling agreements.

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

All producers with a total installed production capacity exceeding 1000 MW.

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

The retail arms of the participating companies will need to buy from the exchange to cover the needs of the company. The bids from the retail arm should be handed in seperately from the offers from the production arm, to help prevent curcumvention of the auctioning requirement. In our view it would complicate things too much to introduce a reserve price.

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

Initially, it should apply to a day-ahead auction only. First of all because this is the least costly measure, and a very significant signal to give to potential entrants. This will enable new entrants to sell and buy the electricity that is needed and lay the foundation for a credible reference price for longer dated products/derivatives.

Question 6: What costs would this option impose?

It would incur costs on the big 6 initially, since they have to adapt to a new way of trading, but we do not think it will be incromprehensibly expensive to implement.

Moreover, a mandatory auction might make it less easy to manipulate the market causing prices to get out of alignment with fundamentals. This might reduce the incubents margins, which is not necesseraly a bad thing.

CHAPTER 7

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

Yes, with the high degree of vertical integration in the UK market, we think it is necessary to apply a self-supply restriction, to ensure that there will be more volumes traded.

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

All companies that own more than 1000 MW installed effect.

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

It should be set as a percentage of current production. We think 10 % is appropriate.

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?

It should apply to short-term delivery (next day).

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

We think that enforceability will best be solved by trading through an exchange. The exchange can then be regulated such that Ofgem obtains a satisfactory overview of the market.

Question 6: What costs would this option impose?

This option would in our opinion be very cost efficient. By letting a professional player, like an exchange handle trading, Ofgem will need less resources to monitor the market. In addition, market participants will have clear rules to adhere to.

CHAPTER 8

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

No. Risk of not fulfilling a contract obligation is an attribute of most markets, and needs to be present in order not to give perverse incentives to participants.

This chapter underlines the advantages of a liquid market and established exchange based trading. With a liquid, transparent market, volatility can be calculated and standard collateral terms can be introduced. If trading goes through a clearing house, it might need to be regulated, but in such a way that it is not put in an unfairly risky position. For the big companies, putting forward the necessary collateral would without doubt be very cheap. Even though a vertically integrated company has been given a self-supply restriction, long and short postions the company holds should be allowed to be netted such that the overall collateral will be very low.

CHAPTER 9

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

Yes, we think the criteria are very well thought through and puts the emphasis on the right areas.

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

The introduction of a mandatory, exchange based, auction.