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Dear James,

Liquidity Proposals for the GB wholesale electricity market

Thank you for the opportunity to respond to the consultation paper regarding liquidity in the GB wholesale electricity markets. This response is on behalf of National Grid Electricity Transmission plc (NGET). NGET is the electricity transmission system operator for Great Britain and is a transmission system owner in England and Wales.

Background

Because of its position as electricity system operator, NGET is prohibited by the licence governing its activities under the Electricity Act from purchasing or otherwise acquiring electricity for the purpose of sale or other disposition to third parties, except for limited system or balancing activities prescribed in the commercial arrangements governing the electricity industry.

As a result, NGET is not an active participant in the forward market for energy in Great Britain. NGET's limited role tends to lead to its participation in the GB wholesale electricity markets being restricted to prompt trading patterns (i.e. within day and day ahead) in order to ensure the residual balancing of electricity supply and demand and manage system security.

Summary

NGET agrees with Ofgem's view of the importance of a liquid wholesale electricity market. NGET highlighted in its recent consultation document "Operating the Electricity Transmission Networks in 2020"[1] that it will continue to be reliant on market participants taking actions to minimise their exposure to imbalance; increasingly so as the capacity of installed wind generation increases. Respondents[2] to

[1] http://www.nationalgrid.com/NR/rdonlyres/32879A26-D6F2-4D82-9441-40FB2B0E2E0C/35116/Operatingin2020Consulation.pdf

[2] http://www.nationalgrid.com/NR/rdonlyres/A14ADB7F-AD60-4979-A7BE-3B736FED4A42/39758/2020FollowUp.pdf

the consultation were in general agreement with NGET's view that future variation in market length would lead to increased balancing activity.

Hence in addition to the removal of barriers to entry for smaller market participants, efficiency of pricing and ability of investors in new generation to manage wholesale market related risks, NGET notes the importance of a liquid wholesale market, and hence parties' continued ability to efficiently self-balance, on its role as residual balancer.

NGET continues to think that, while it is prudent to allow existing measures to improve liquidity, such as the N2EX trading platform, a chance to develop, it is important to explore further measures to improve liquidity, both in the short-term and looking further ahead towards 2020.

The remainder of this response provides NGET's thoughts in relation to the specific questions asked within the consultation document.

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?

Low levels of liquidity can cause harm to markets and if industry initiatives do not counteract the fall off in liquidity then policy intervention is merited. However it is not clear how long industry initiatives should be given to rectify the situation. The most recent (N2EX) still has relatively few members, although there are greater numbers indicating a willingness to sign up to the platform. It may then take several months to a year to see if it is likely to be a success.

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

Yes.

CHAPTER: Two

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

Yes, the high level success criteria would appear to appropriate as they address the key issues of market participation and product availability across different timescales which will then drive liquidity.

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

Volumes and availability levels could be benchmarked against comparable power (not gas) markets. It should not be expected that volumes increase to Nordpool levels in the near future, but a churn rate of 3 to 5 times physical could be deemed reasonable in the short term until more non-physical players enter the market. Key barriers to entry for small players have been getting GTMAs and subsequent credit arrangements in place. A key success measurable for N2EX could be to see these barriers reduced (through introduction of clearing) and hence an improvement in use by small players would be beneficial. Feedback from small suppliers would be welcome but of course will be qualitative rather than objective and hence appropriate weighting of answers should be considered.

Question 3: When should market success be judged?

Success could be deemed when liquidity levels have improved significantly and a trusted reference price has been established and agreed by a majority of participants. Evidence this is the case might be through the emergence of a cash settled contract. Success should be seen as evolutionary, but increasing numbers of entrants actively using the platforms could be considered a success.

CHAPTER: Three

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

The policy options noted in Chapter s 4 to 8 would appear to be the most appropriate for addressing liquidity issues in forward markets.

CHAPTER: Four

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

If correctly structured, a direct trading obligation could help wholesale market liquidity, however it should be implemented along open access to all rather than ring fencing volumes for small suppliers, as this may lead to a diffusion of liquidity to a number of different pools.

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

NGET has no view as to which licensees are subject to such an obligation; however it would seem appropriate that obligations should be attributed on a market share threshold.

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

Pricing and products should be made available to all participants to ensure separate liquidity pools do not arise. However consideration to competitive credit terms should be made for smaller participants and a clearing solution (as offered by N2EX) may go some way to providing more efficient credit and collateral options for small players.

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

NGET does not have a definitive view on this, although it is not clear that there is a problem for small generators selling their output and hence obligations on supplier licensees are probably not required.

Question 5: What costs would this option impose?

NGET feels it has insufficient knowledge in this area to offer substantive comments.

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?

A market maker would be useful as a first step. However, the market maker should operate within the broader wholesale market to ensure liquidity is pooled and there is not divergence of price. The key is that smaller clips of the products are offered within the broader market.

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

See previous answer.

Question 3: What volume obligation would be appropriate?

The volume requirement could be set at a level higher than the current “independent” (i.e. % of market not held by Big 6) sector volume requirement. This may encourage new entrants into the market who would be sure of being able to hedge their requirements. The volume requirement would need to monitored and adjusted and, as noted in chapter 5 of the consultation, be priced within a tight spread.

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

A market making agent may provide a more transparent means of doing this but it is the licence obligations that will make it work. An agent may just provide a more efficient and auditable means of doing this and could act as a monitoring agent to Ofgem.

Question 5: What costs would this option impose?

Any cost would come with the monitoring of the obligatory bids and offers rather than the implementation costs, which are likely to be negligible.

CHAPTER: Six

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

Mandatory auctions would be a good way of concentrating liquidity at one point in time; however there may be a subsequent impact on liquidity within continuous markets. They would provide a robust reference price, which has been instrumental in Continental markets to the development of liquidity. One issue for the GB market is the close interaction with the gas market where some parties would wish to hedge spark spreads etc and as gas is an End Of Day balance, if liquidity was drawn to a particular point in the day this could introduce more basis risk.

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

The volume submitted into a mandatory auction should be related to underlying physical fundamentals (supply/demand) in order that it is representative of the physical market and hence created a trusted reference price from which participants would be willing to enter into cash settled contracts.

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

For generators with a portfolio of generation assets that exceeds a certain threshold, a proportion of their generation fleet could be put through an auction. However it will need to be set based on requirements of the supply side also. For example, many supply companies may not wish to take a large un-hedged position to a day-ahead auction and hence it may mean longer dated auctions are required. However as noted above, day ahead auctions will need an element of demand side to ensure the prompt auctions do not just become a means of generators optimising or trading shape between generation portfolios. The extent to which the demand side participates in prompt auctions may depend on there ability to acquire shape through structured products. In particular, vertically integrated (VI) participants may currently achieve this through the internal transfer between businesses.

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

See above.

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

Longer dated forward product auctions would be useful on a rolling basis to avoid short term factors (news, fundamentals) etc feeding into prices and as noted would allow adjustments to positions more readily. Longer term auctions would also potentially lead to more volume for longer dated products on platforms and aid price discovery in these time horizons, which is critical to investment.

Question 6: What costs would this option impose?

NGET feels it has insufficient knowledge in this area to offer substantive comments.

CHAPTER: Seven

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

A self supply condition may counteract the perception that VI participants internalise a lot of volume. However, this will be done at an internal transfer price. It may be more appropriate for the publication of internalised price transfers either to the industry (on an aggregated basis) or to Ofgem, who could then monitor against wholesale market prices. Even in VI businesses, both retail and generation arms should be looking for the best price. Such a requirement (internal transfer prices) being published may be sufficient in conjunction with some form of mandatory auctions.

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

NGET is not in a position to comment.

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

The self supply restriction, if introduced, would ideally be across all customer groups, although it would appear from Ofgem's previous consultations that obtaining volume from wholesale markets for industrial and commercial customers is not a problem.

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 above.

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

NGET feels it has insufficient knowledge in this area to offer substantive comments.

Question 6: What costs would this option impose?

NGET feels it has insufficient knowledge in this area to offer substantive comments.

CHAPTER: Eight

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

Yes – see earlier responses.

CHAPTER: Nine

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

The proposed assessment criteria seem reasonable.

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

See preceding answers.

If you wish to discuss the content of this letter further or have any queries please contact either myself or Ian Pashley on 01926 653446.

Yours sincerely

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