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GB Markets

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Liquidity Proposals for the GB wholesale electricity market

Dear Sir,

Thank you for the opportunity to comment on the above consultation. This response is provided on behalf of the RWE group of companies, including RWE Npower plc, RWE Supply and Trading GmbH and RWE Innogy GmbH.

We do not consider that liquidity is the issue it is made out to be; *a major barrier to new entrants coming into the electricity market*. In our view the main reason for the lack of new entrants in the retail market is the lack of profitability, not liquidity. We should also not lose sight of the fact that the GB market is the most competitive market in Europe for electricity and gas[1].

The electricity market has proved to be the means for developing robust lowest cost solutions and will continue to do so, if allowed. In our experience regulatory intervention very rarely provides the right answer and often requires further changes in the future. We believe that this would be the case with the proposed solutions.

Having said that, RWE agrees that there is room for improvement in the level of liquidity in electricity wholesale markets. This would lead to greater confidence in the market and the price signals it produces and the competitive process in general.

However, the view that a "vicious cycle is underway" or that the market has settled on a low steady state equilibrium as described in Annex 4, we consider to be something of an overstatement. If this were the case, liquidity would have continued to decline whereas, as the document notes, liquidity has increased since 2006 and continues to do so. In 2009 RWE estimates that the power market traded with a churn rate of 4.3, more than double the churn rate in 2006. Similarly as noted in our response to the June 2009 Discussion Paper, higher levels of liquidity in continental markets is not indicative of effective competition in those countries.

In terms of whether policy intervention is merited, we do not consider that the liquidity issue is, per se, a major barrier to new entrants coming into the electricity market: rather, relatively low liquidity has been a symptom of other barriers to joining the physical market. We believe those other barriers to entry should be the real focus of change.

[1] European Commission, report on progress in creating the internal gas and electricity markets; Technical annex (11.03.2009)

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As you are aware, RWE is one of the main sponsors of the launch of the N2EX market which was launched with the objective of reducing barriers to electricity trading. The new market went live on 11 January 2010. The exchange now has 15 members and the daily auction is already reaching volumes of 5-10GWh. It is our view that this platform, once adopted by the main industry participants, has the scope to meet Ofgem's concerns about electricity market liquidity and that the focus should be on facilitating this process rather than seeking to design interventions to artificially promote liquidity which risks being self-defeating or replicating the competitive process.

We would also like to make the point that Npowers' current product offering ensures access to the wholesale market for customers who want to manage their price risk. Inevitably typical customers with appetite for such products have dedicated procurement professionals and/or use intermediaries. The product divides customer positions according to the number of purchasing decisions that the customer requires - which inevitably results in tranches of volume in both 'standard' lot size (10MW) and non-standard lot size. Currently npowers portfolio of in excess of 22TWh/annum which is supplied using this product structure, enables 85% of customers purchasing decisions to be made on non-standard lot size transactions in the wholesale market.

Yours sincerely

AMcAdam

Alan McAdam
Economic Regulation

Responses to specific questions.

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 believe that the perceived low liquidity is a symptom of other barriers to market entry, not least the requirements to sign the Balancing and Settlement Code and 20-30 GTMAs with individual counterparties. Liquidity is one of a number of issues that the market is trying to resolve and we believe that it is often used as a general term in this context. Other issues at least of equal importance are credit, shape and product size. The market recognises the issues and is working hard to improve all the above aspects. It is our belief that the proposed policy interventions will stifle this innovation and stop the gradual increase in liquidity that we are seeing.

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

We agree that the focus should be on electricity.

Chapter 2

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

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

Question 3: When should market success be judged?

With respect to timing, the evaluation period set out in the consultation is too short. For example, one of the factors contributing to lower liquidity for longer dated products is the impact of the lack of visibility of the carbon price after 2012. This issue is far from being resolved and the Regulation setting out the process for the auctioning of Phase 3 certificates has only recently been published in draft by the Commission. Another factor currently affecting liquidity is the effect of the allocation of Phase 2 CO2 certificates. Taking these points into account would suggest that Ofgem's assessment period needs to run until the end of 2012 at least.

Having said this, some interim progress is clearly needed and this should focus on the current industry initiatives as follows.

- Number of participants in the day-ahead auction including non big six financial intermediaries, potential new entrants and large consumers.

  We would expect a significant increase on the numbers of participants from the current level of 15 by the end of 2010.

- Volume of day ahead trade passing through the day ahead auction

  The objective here should be a shift from non-cleared OTC trading to cleared auctions at the day ahead stage. Of the current day ahead traded volume of ~200GWh per day, we would ultimately expect a large proportion to be dealt through the auction. Until forward financial trading replaces forward physical trading, placing more emphasis on the auction as a tool for despatch, we consider auction participation of 10% day ahead volumes, or 20GWh per day, to be a level which gives enough confidence for companies to trade derivatives based on the auction reference price.

- Existence of forward baseload / peakload derivatives on the basis of the day ahead auction.

The following derivative products by the end 2010 should be available: Baseload and peak financial derivatives for the front 2 ½ to 3 years.

These indicators will give a good indication of improvements being made to the contestability of retail markets. As noted above, however, this will not necessarily lead to rapid changes in markets structure. While improving liquidity may facilitate market entry, it will certainly not guarantee it. We have not seen any evidence that liquidity is in fact the main barrier to new entry. In our view, the key factors are the low margins which have been available in retail over the last several years and the requirements for a company to be regarded as an acceptable counterparty.

In general, all though it is obviously important to listen to all actual and potential market participants, we do not think it advisable for the regulator to set itself a formal target that can only be delivered by the actions or opinions of certain individual companies. The risk of such an approach is that it is then in those companies' interest to demand more and ever higher concessions.

Chapter 3

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

We welcome and support Ofgem's conclusions relating to the options which are not being taken forward.

Ofgem is correct in noting that the cash out arrangements have a significance that goes beyond the question of liquidity in that they need to give important signals to support security of supply. Sharper price signals would go a long way to encouraging trading and also address many of the issues discussed in Project Discovery. Improved cash out arrangements would also encourage demand side participation without necessarily needing specific measures.

Similarly, Ofgem is right to conclude that intervention to change industry structure would be not proportionate to the problem. We do not consider that vertical integration removes the reason to trade as there will always be an ongoing mis-match between generation assets and retail requirement. As we stated in the response to the original discussion document, RWE npower generation and retail businesses interact with the market through the RWEST trading business and only net approximately 10% of volume. It is expected that there will be an increasing tendency for other companies to follow such an approach. It is also worth noting that enforced divestment of retail and/or generation businesses could lead to a higher level of concentration and higher costs by eliminating efficient business models.

Neither is vertical integration a barrier to entry. Large generators are usually prepared to do an origination deal around their assets and some sites have recently been available for sale (Uskmouth, Eggborough).

Finally, we agree with Ofgem that better alignment with other European markets on the basis of implicit auctions will also improve liquidity and help encourage new market participants. We have responded to Ofgem's consultation on interconnector policy along these lines. Integration of the GB market into existing cross border initiatives would also contribute to resolving issues identified in Project Discovery.

Chapter 4: Direct Trading Obligation

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

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

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

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

Question 5: What costs would this obligation impose?

We believe that what market participants (including small suppliers) need is a set of transparent and credible prices across a range of different products (base, peak and shape) and across time periods. We believe that this will be best provided through a market platform in which all companies feel comfortable participating in terms of the cost, risk and simplicity. This is what the industry is trying to achieve through the N2EX platform. Once reliable reference prices are established, the issues identified by e.g. small suppliers in terms of the range of products and the time taken for counterparties to process requests will disappear, as there will be no need to enter into such complex processes when the prices for what is required will be transparently determined and visible.

With this in mind, we do not therefore consider it useful to impose direct trading obligations as a licence condition or guidelines. Such a measure would substitute for trading rather than increase liquidity. This would be particularly damaging if there were reference to how prices should be determined in the guidelines. For example, it would be difficult to establish a benchmark price from the traded market at the same time as introducing a measure that would displace such trading. Alternatively, using internal transfer prices could be something of an artificial process. It would be preferable to encourage such transactions to be undertaken through traded markets such as N2EX.

We agree with Ofgem on the complexities of policing any such requirement and would suggest that the costs would be considerable.

Chapter 5: Market Making Agent

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?

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

Question 3: What volume obligation would be appropriate?

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

Question 5: What costs would this option impose?

As far as the "market maker" function is concerned, while we acknowledge the need for companies to be pro-active in supporting trading, we have considerable reservations about some aspects of the proposals in the document. In some respects, the solution being advanced appears to create a monopoly for the market maker function, which is unlikely to be cost effective compared to such a service evolving spontaneously. The paper also fails to recognise that not all the big six companies are in the same position in being able to take up such a role.

In addition, the various examples from other European states are not relevant to the situation in the GB market. In cases such as Denmark, the establishment of a quasi-regulated market maker was partially a response to the high level of market dominance of the main generator. This is not the case in the GB market and there is no "dominant utility in the region" as referred to by paragraph 5.7 of the consultation.

Market making involves taking on risks and this needs to be recovered in the bid-offer spread. We think it would, in practice, be impossible to establish a sensible regulated bid-offer spread given the rapid evolution of market conditions. The likely result is that the spread would always be "wrong" to some extent. The level of this charge would also become the subject of lobbying by market participants with diverse motivations.

In summary, the view of RWE is that the role of market maker should evolve spontaneously in the market and that the companies best placed to take on this role will emerge as market makers.

RWE is already acting a significant liquidity provider in the N2EX auction. N2EX should be encouraged to provide details on market making terms to the market.

Chapter 6: Mandatory auctions

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

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

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

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

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

Question 6: What costs would this option impose?

As noted in the previous discussion, RWE is of the view that the N2EX platform will lead to an increase in the volume of trading, the range of products and bring in new wholesale market participants. We do not see that a replication of this exercise by the regulator would serve any useful purpose. Indeed there is a real risk that a regulatory process would detract from the existing industry initiatives.

We believe that volumes will progressively grow on the N2EX platform, for example as a result of market coupling across the Britned and IFA interconnectors. As a result we do not consider it appropriate, at the current time, for participation in any particular market to be mandatory since there are a number of forces that will have the effect of increasing traded volumes. The more that any process is mandatory, the more likely it is to substitute for existing trading and thereby reduce liquidity in forward markets.

Likewise, we do not support compulsory auctions for forward products. This would be similar in effect to a divestment requirement which Ofgem has already rejected earlier in the report, particular if there were restrictions on price or the range of participants. The virtual power plant auctions in other countries referred to in the document were largely designed to address market power concerns, which are not present in the GB market. Such an auction would undermine market prices and give incorrect economic signals. Forward auctions would tend to crowd out market activity in forward markets which are already relatively liquid.

It is also our view that potential restrictions associated with participation in such methods would be inappropriate. For example placing restrictions on existing supply businesses would merely create an unwarranted source of earnings for financial intermediaries.

Chapter 7: Self-supply restriction

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

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

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

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?

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

Question 6: What costs would this option impose?

With respect to the self supply restriction, we agree with Ofgem's assessment that this would be very difficult to monitor and enforce. It would not necessarily help smaller suppliers since it may lead to companies swapping volumes in a one-off exercise. Ultimately such as restriction is no different in practice to a compulsory auction as recognised in 7.14.

Chapter 8: Collateral requirements

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

We do not believe that this should be pursued further; Companies should be left to make their own judgements about the creditworthiness of counterparties.

We expect that as N2EX develops and attracts more participants, this is likely to lead to a reduction in collateral requirements.

Credit requirements are a part of doing business. RWE applies the same credit assessment criteria to small businesses as to large businesses. For counterparties required to post collateral, having all collateral in one place can be significantly more efficient than having collateral spread over many bilateral counterparties.