20 April 2010

Spark Energy Response to OFGEM Consultation on Liquidity Proposals for the GB Wholesale Electricity Market. Reference 22/10.

Overview

Spark Energy sees three major issues arising from the current wholesale market arrangements that provide significant disadvantage to small new entrant suppliers to the mass market sector. First, the size of each trade required by a small supplier is significantly smaller than the 'normal' size for market trades; second, there is little availability of products that would allow a small supplier to match any hedge to the profile of their aggregate customer demand; and third, that the collateral requirements are disproportionately expensive for small new-entrant suppliers. These combine to provide significant structural competitive disadvantages to new entrants. The three issues are inter-related and all three need to be addressed to provide an environment that would support and encourage the development of competition in mass market electricity supply. The collateral issue impacts the gas supply market in a similar manner, hence any measures addressing this issue should be applied across both markets.

Spark Energy's experience is that the first issue identified above can be overcome – but only to the extent that the small supplier is not constrained by the third – i.e. only subject to stringent requirements for collateral to support any forward hedges purchased. The cost of collateral places a disproportionate burden on new-entrant suppliers.

The second issue identified above, the availability of suitable products to hedge profile, may also be addressed – again at a cost. The MVRNA arrangements available under the BSC provide a potential solution, and there are parties willing to provide hedges on that basis, but only on terms that impose a very heavy burden in terms of collateral requirement. In any event, such arrangements only work if they are provided on an exclusive basis – so for their duration they distance the small supplier from the wholesale market. The prompt markets are effectively closed to small suppliers due to the size of trade they would wish to execute.

The third issue, that of the disproportionate cost to new-entrant suppliers of collateral to support a forward hedge is, therefore critical, and without a solution to resolve this issue there will never be an environment that supports and encourages the new entrants to develop completion in the mass market for electricity (and gas) supply. The 'Big 6' suppliers all have the ability to trade through rated entities. Based on their financial status, trading counterparts will be willing to trade within agreed credit limits, and beyond those limits they will be able to provide (at low cost to themselves) letters of credit or parent company guarantees to support additional trades. New entrant suppliers do not have this luxury. Typically they will have insufficient history of financial stability to secure any unsecured credit limit for trading, and banks will either charge high fees or refuse outright to provide letters of credit. Such suppliers therefore have to provide cash as collateral to support their hedging activities, and that cash will, effectively, be equity – making it far more expensive than anything provided by the Big 6. One way around this would be to set up an industry backed body that would enable the new entrant suppliers to make use of their key asset – their customer base – to secure collateral at reasonable cost that could then be used to support a forward hedge. The industry would be able to provide such financial backing at minimal risk if the Supplier of Last Resort arrangements were modified to require that forward hedges supported through the industry body would automatically transfer with the customers. An arrangement of this kind would not lower the requirement on all suppliers to ensure that they were adequately capitalised and able to meet their day to day obligations, but would remove a barrier to procurement of a forward hedge consistent with industry norms.

The remainder of this response covers the Spark Energy's views on the specific issues raised by OFGEM in the consultation document.

Chapter 1

We do believe that intervention is appropriate. We consider that the single most important issue that should be addressed is the disproportionate cost of collateral for new entrant suppliers, but that there are also substantive issues relating to access to forward hedging products in appropriate lot sizes, particularly in relation to products to hedge profile risk. Any measures introduced to address the cost of collateral should be applied across both electricity and gas markets.

Chapter 2

The key issues relate to the availability of products that hedge profile and that may be purchased in appropriate clip sizes without disproportionate funding costs. The volume of trades in standard products and availability of longer dated products will not, by themselves, be any indication of success. Success may only be measured through the impact on smaller independent suppliers.

Chapter 3

We believe that the approach we outlined above to address the disproportionate cost to new entrant suppliers of collateral to support purchase of a forward hedge should be considered as a development of or alternative to the options outlined in chapter 8.

Chapter 4

We believe that there would be merit in requiring the major vertically integrated companies to offer both swaps (baseload to ex-ante profile 1-4) in small clip sizes – say at a granularity of 1MW for the baseload element of the swap - for up to a year ahead. These products should be subject to minimal collateral requirements, consistent with their zero net volume. The major vertically integrated companies should also be required to offer existing standard baseload and peak products in small clip sizes up to 18 months ahead.

Chapter 5

A market maker might provide an alternative solution to the swaps and small clip sizes for standard products referenced in our response to chapter 4 above.

Chapter 6

Auctions will only improve conditions for the growth of new entrant competition if the issues relating to the disproportionate cost of collateral are addressed. Regular monthly auctions of 12 month hedges based on standard baseload and peak products with appropriate clip sizes would be useful and might be of particular use to new entrant suppliers serving the I&C market sector.

Chapter 7

We are not clear what benefits this would bring.

Chapter 8

As noted throughout this response, we believe that the disproportionate cost of collateral provides a significant barrier to the development of competition through the growth of new entrant suppliers. We believe that there should be an industry backed arrangement under which small suppliers could use their customer portfolio as collateral to back some form of credit support instrument that might in turn be used to support purchase of a forward hedge. The amount of credit available would be best defined in physical terms and related to the size of the customer portfolio.