cornwallenergy

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Ofgem
9 Millbank
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Dear Vanja,

Re: GB wholesale electricity market liquidity: summer 2010 assessment

The contents of this response have been discussed with the members of our monthly Energy Supplier Forum[1]. This letter does not purport to represent a view from the smaller suppliers, but the arguments set out here are supported by many of the individual members. Most members will be submitting their own responses to this consultation and have engaged bilaterally with the regulator.

Our belief that Ofgem should not wait and see if the market will deliver the necessary response, via exchanges, to materially improve liquidity, still holds true. Indeed the assessment noted that weaknesses in longer term liquidity are still present, price transparency has not improved, and: "The majority of respondents did not feel that the wholesale trading conditions for independent market players were broadly sufficient to support contestability and their participation in the wholesale market. Whilst there was some satisfaction with the prompt market, the longer term market, particularly for products for two years and further out, was considered inadequate."

As we set out in our response to the earlier consultation[2] on this topic, and worth repeating here, the current situation has arisen despite current electricity trading arrangements being premised on the development of healthy traded markets in the absence of a centralised pool. Rules for residual uncontracted supplies were deliberately framed to incentivise parties to trade on the market, but in practice many independent players can not do so because of the basic illiquidity compounded by shape, timing and size issues. Market designers failed to see that inherent volatility in commodity prices would lead those players that are able to integrate in preference to contracting. Therefore although the relationship between traded markets and the rules for uncontracted supplies was intended to boost competition, in practice, it has undermined it.

When developing any possible regulatory interventions further Ofgem should give greater consideration to the conditions faced by independent suppliers to ensure that solutions will actually deliver the desired outcomes. These include issues such as the cost of joining and continuing membership of exchanges, credit arrangements,

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[1] The Energy Supplier Forum is a Cornwall Energy hosted monthly meeting that brings together many of the smaller energy retailers in the market to discuss pertinent regulation and policy issues. More information here: http://www.es-net.org.uk/

[2] http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/Documents1/Cornwall%20Energy%20Response%20to%20discussion%20document.pdf

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and resources required to complete trading negotiations, against a background of unpredictable policy and regulatory development that itself requires significant resource to keep abreast of.

I have also enclosed a perspective piece from the 245th edition of our *Energy Spectrum* weekly newsletter as an annex to this response. I am happy to discuss these issues further.

Yours sincerely,

Nigel Cornwall

Liquidity allsorts

In its recent summer assessment of wholesale electricity liquidity, Ofgem indicated that it was still making its mind up about whether to intervene to improve the current situation. In this Energy perspective we argue that the regulator's wait-and-see strategy—providing encouragement to industry initiatives to provide greater liquidity prior to determining whether further action is necessary—is now delaying much-needed reforms in the face of strong evidence it should expedite the process This hiatus is to the detriment of the market in general and to the disadvantage of smaller market participants in particular.

The latest document follows up Ofgem's February consultation, which in turn was the outcome of last June's examination of wholesale energy market liquidity. It gave the gas market a clean bill of health but recognised severe distortions in electricity.

The February consultation set a framework for assessing the performance of the market, which Ofgem has now applied to the situation as of summer 2010. Ofgem has indicated a preference for the market to deliver solutions to address its concerns, but it said intervention could be merited if they failed to do so. It will have one further look, around the end of the year, before finally deciding whether intervention should be initiated.

Ofgem's assertion that its market has produced a "mixed" set of results shows on closer reading to be two out of three areas for comment with a "mixed performance with a negative bias", and a "mixed performance with a positive bias" in the other. This more favourable evaluation relates to its criterion of high volumes in standard products.

Ofgem Project Discovery

"Our assessment suggests that low forward liquidity in power markets and uncertainty surrounding future carbon prices and subsidy levels are key risk factors facing investors." (3.11, Feb consultation).

Energy Market Assessment

"The main reason for the lack of independent activity is likely to be the barriers to entry in both wholesale and retail markets. The primary barrier is low wholesale market liquidity. The lack of liquidity arises from the vertically integrated companies "self-supplying" their electricity … and/or entering into long-term contracts with independent generators, which ultimately means there are low volumes of electricity available to trade on the wholesale market. This makes it hard for new entrants into the retail market to obtain the volume and range of electricity wholesale products at the predictable prices that they need to compete." (2.22)

Yet even here the evidence in support is highly ambivalent. There is strong improvement in churn (but from a 2005 low), and Ofgem acknowledges that levels remain well below the more liquid power markets. While near-side bid-offer spreads have fallen in 2010 from levels seen in 2008 and 2009, spreads further along the curve have increased, with spreads for peaking products up 50% from 2008 levels. The proportion of exchange trading also remains significantly lower than in other electricity markets. In particular there is limited forward trading and "over-the-counter" (OTC) traded volumes that are given up for clearing.

The opening of the N2EX in January is cited by Ofgem as a key recent development. Much of the reason for the regulator's reticence to act seems to hinge on expectations that the new exchange might materially boost the market. This platform has three product areas, a continuous spot market, a prompt market and a day-ahead auction, and there are plans to develop a financial derivatives market. But remembering that Ofgem first looked at wholesale markets due to fears they might be distorting retail competition, this focus seems to forget that the problem is not prompt trading but trading of shape over the forward curve. With a concerted push from the market operator (the facility has the support and engagement now of the Big Six and 10 other participants) progress has been made but there is little sign yet that N2EX is making any significant difference in the areas of greatest concern.

Since the lack of liquidity is routed in deeper structural problems and the levels of vertical integration in the electricity sector—rather than the availability of trading platforms—this should not be a great surprise. Auction volumes, while stable, are significantly lower than other European countries (for example auction volumes in Germany were 39% as a proportion of consumption in the first five months of 2010 compared to 0.6% in GB).

Prompt volumes at around 160GWh/day are also significantly lower than in other benchmark markets, and these are OTC trades given up for clearing rather than originating on the exchange itself.

Reading between the lines, it does seem Ofgem is trying very hard to accentuate the positives. Why use terms like "mixed with a positive bias" if you actually mean "inadequate but not as bad as it was".

The other two criteria areas, availability of longer-dated products (including financial derivatives) and meeting independent market participants' requirements were classed as a "mixed performance with a negative bias" (to us "poor and deteriorating"). Indeed all the market participants who responded to Ofgem's questionnaire agreed that they had not seen any improvements in liquidity further along the forward curve or any new, longer-dated or financial product being made available in the past six months. There has also been a decline in the volume of baseload trading further along the curve, although the report notes a modest increase in forward trading of off-peak and peak products.

But it is in respect of the last criteria on meeting independent participants' needs—which is where we think the debate should be focussed—that some of the most worrying evidence is to be found. "The majority of respondents did not feel that the wholesale trading conditions for independent market players were broadly sufficient to support contestability and their participation in the wholesale market", the regulator reported. There was particular dissatisfaction with the longer-term market, two years and further out. Smaller participants are concerned about the availability of products with small clip sizes, which they see as a barrier to entry and growth. They said that some of the products they need in order to hedge are not available, and that product diversity has actually fallen from 2003 levels, with trade concentrated in a few products of little relevance to them.

In short even with the advent of N2Ex there have been no further fundamental market changes: the market is meeting the differing needs of large integrated participants but not independent ones. Moreover none of the other developments Ofgem highlighted in February—such as the Britned interconnector, growth of the demand-side and the impacts of European legislation—could have any impact on liquidity in the timescale that Ofgem has set itself for decision.

Against this background it is disappointing that Ofgem has not developed further any of the outline remedies from the February consultation. It has only said they are continuing to be developed, influenced by respondents' comments on design issues. A new angle is a concern that there is a need to ensure that any interventions could be integrated with any overall package of energy market reforms, which the Government may decide to introduce. But given official comments in the April Energy Market Assessment (see box on previous page); this position seems to be playing for time. We think there is clear and mounting evidence that the liquidity Ofgem wishes to see is just not developing.

Nearly four months on from our last comment (*ES231, pp2-3, 10/05/10*), we still feel a modest targeted obligation on the Big Six to offer terms and appropriate product similar to those available to their own supply business is the right way forward. Combined with a market maker there would be a party quoting firm bid and offer prices for a given product, and who accepts and manages the ensuing risks. The idea is that the market maker would provide products of value to smaller participants, for example with small clip sizes, which are not available to them through other routes.

The priority now should be to urgently develop and assess workable solutions. The process being followed is too slow and drawn out given the weight of evidence that has already been gathered, and it is now over two years since the select committee registered its concerns. It is hard to see what further analysis can achieve. The official view has been well-aired in the energy market assessment, and the new administration seems to share the concerns of its predecessor that the market is not well-functioning. While it will be impossible to suit everyone, the current situation is leaving too much to a market used by a handful of players to manage their own balancing risk and which by any objective measure is itself immature. Like a sherbet fountain, after an initial burst of flavour, the effervescence has stopped and the work-stream is starting to leave a rather sour taste in the mouth.