Ofgem's GB wholesale electricity market liquidity:

Summer 2010 assessment

E.ON's Response

Ofgem's GB wholesale electricity market liquidity: summer 2010 assessment clearly targets the two largely separate issues of wholesale electricity market liquidity and support for small independent market participants. The differences between these two issues means that any assessment needs to involve different metrics and timeframes for each of them.

We remain sceptical that improvements in liquidity will have any significant impact on the suitability of the GB wholesale electricity market for players wishing to trade very small volumes or having small capital values. Likewise, actions to support artificially the activities of small independent market participants are unlikely to promote improvements in liquidity, with many potential actions likely to harm market confidence and thus liquidity.

If it is Ofgem's desire to support players wishing to trade very small volumes or having small capital value, then we continue to recommend that Ofgem looks at specific mechanisms focused on helping such players. An example of such a mechanism would be voluntary volume aggregating arrangements that would operate outside the main wholesale market. This would allow small suppliers to procure product in clip sizes smaller than available in the wholesale market. We described such mechanisms in our April 2010 response to Ofgem's "Liquidity Proposals for the GB wholesale electricity market". Ofgem's next formal assessment of the market's performance would be ideal for evaluating such mechanisms.

In respect of liquidity, Ofgem's proposed framework for assessing the performance of the market, if combined with a greater recognition of the effects of changes in other energy markets, is a reasonable but a complex way of assessing both liquidity and the support for independent market participants. However, this will only be so if those metrics that relate to liquidity are only used for assessing liquidity. Equally, those metrics that relate to assisting smaller players, and not to the assessing of liquidity, should be used only for assessing support for small independent market participants.

While current levels of liquidity are below the recently projected levels, a positive impact on liquidity is expected in 2011. This will be an increase in market coupling, through the commissioning of the BritNed interconnector. The BritNed interconnector offers a number of positives for trading, including further development of day-ahead auctions, which are not seen on the existing interconnectors. It may be that such market coupling can overcome some of the possible causes of the recent lower levels of in liquidity.

With a positive development, such as the BritNed interconnector scheduled for 2011, the end of this year seems premature for concluding that industry led initiatives will, or will not deliver the required improvements in liquidity. The end of this year will, however, be an ideal opportunity to review liquidity developments during 2010.

Answers to Ofgem's specific questions

Appendix 1 sets out Ofgem's summary of its findings and the group metrics referred to in the following answers.

Chapter 2 Proposed metrics

Question 1: Do you agree that the proposed framework provides an adequate range of evidence for assessing market liquidity?

Groups 1 and 2 metrics will provide a broad range of evidence from which an assessment of market liquidity can be made, although the broad range seems to be an overly complex way of assessing levels of liquidity. Liquidity is about overall levels of churn, the number of times a unit of power is traded within the wholesale market. This is encapsulated by Metric 1 (Aggregate churn: volumes traded across all products / GB physical consumption). We therefore suggest that for assessing market liquidity the focus is on Metric 1.

Group 3 metrics will probably provide an adequate range of evidence for assessing levels of support for small independent participants. Group 3 metrics are not suitable for assessing market liquidity.

There is increasing influence on the GB electricity wholesale market of interconnection and of the UK gas market, which in itself is increasingly affected by international markets. Therefore, to assess both market liquidity and support for small independent participants, we would like to see the metrics supporting analysis of developments in the GB electricity wholesale market not only being set against developments in the wider European and world energy markets, but also set against the reasons behind the developments in those markets used for comparison.

Chapter 3 Preliminary assessment

Question 1: Do you agree with the assessment of the metrics in this chapter?

Group 1 metrics - High volumes in standard products (Metrics 1 to 3)

Metric 1 - aggregate churn: volumes traded across all products / GB physical consumption,

While agreeing with the first part of Ofgem's conclusions on Metric 1, namely, "that strong improvement in overall levels of churn, with churn forecast to rise to five in 2010", we do have comments on the second part of the conclusion that "churn remains below levels in the most liquid wholesale electricity markets" and some of the more detailed observations made by Ofgem.

Ofgem statement - "overall levels [in the GB wholesale electricity market] remain below those observed in other liquid electricity markets"[1].

It is correct that liquidity is higher in the German and Nordic electricity markets, but the GB electricity wholesale market is more liquid than the other two countries, Netherlands and France, listed by Ofgem. Indeed, it is our understanding that, with the exception of Germany and the Nord Pool, the GB wholesale electricity market is more liquid than any other European electricity wholesale market.

Comparisons with other markets are very helpful, but they should reflect the dynamics in those markets. This would allow developments in the UK market to be considered in the context of developments in the wider European and world energy markets. For example, if growth is limited across most markets, then limited growth in the UK should not be seen as a failure of the GB wholesale electricity market but a reflection of a general trend.

Ofgem statement - "The introduction of Feed-in Tariffs (FITs) in the GB market could also have a positive impact, through incentivising additional, low carbon generation; the additional energy will ultimately need to be traded in the market to enable system balancing." [2]

We assume that Ofgem is referring to the availability of FITs for small generation uses, say domestic and SME. In our view, it is unclear if FITs will result in more or less trading than before, and thus have a positive impact on liquidity. Given its size, most FIT generation will probably be purchased directly by, or on behalf of, suppliers who will net it off from their demand. As a result this generation may not directly enter the wholesale market, but just change the net position already being traded by suppliers. Also, low carbon generation entering the market is not "additional" energy; rather it is just replacing other existing forms of generation that was probably being actively traded by generators and contributing to liquidity.

Ofgem statement - "a high churn ratio could simply reflect very high levels of trading undertaken between large, incumbent market participants"[3].

Achieving a high churn ratio, and thus high liquidity levels, through very high levels of trading undertaken between a small group of players is a good example of why we remain sceptical that improvements in liquidity will have any significant impact on the suitability of the GB wholesale electricity market for players wishing to trade very small volumes or having small capital value.

A very high level of trading, even if undertaken between a few large, incumbent market participants, is still a positive development for higher levels of market liquidity and a benefit to the market as a whole. If a rise in liquidity is because of a few players' trading activities, the questions should not be about the form of the liquidity, but rather why are other players not participating? Equally, any concern, in relation to Metric 3 – use of platforms which promote price transparency, that "market concentration on the main GB

[1] Ofgem GB wholesale electricity liquidity: summer paragraph 3.10
[2] Ofgem GB wholesale electricity liquidity: summer paragraph 3.11
[3] Ofgem GB wholesale electricity liquidity: summer paragraph 3.12

electricity exchange is low but increasing"[4] needs addressing by again asking why are other players not participating? Both situations need to be addressed as part of analysing the findings in the Group 3 Metrics - Meeting independent suppliers' and others' wholesale requirements (supporting retail and broader contestability).

Metric 2 - Bid-offer spreads for range of standard products

We generally concur with Ofgem's observation that there is a widening of spread for products further along the curve although some narrowing for products closer to delivery. However, bid-offer spread, like liquidity, is only one of a number of indicators of market efficiency. Therefore, while relevant to assessing market efficiency, we question whether it is necessarily relevant to assessing another market efficiency indicator, market liquidity. For example, trading activity may hold up in a given market even though tightness in that market leads to widening of bid-offer spreads.

Metric 3 - Use of platforms which promote price transparency

We generally concur with Ofgem's observation of "limited exchange based trading; slight improvement in recent years" and that "N2EX trading provides some positive signs". However, with the exception of the German market and the Nord Pool, we question the claim that the GB wholesale electricity market's trading is "well below other markets".

Group 2 Metrics- The availability of key longer dated products (including financial derivatives) (Metrics 4 to 6)

Metric 4 – volume of trading along the forward curve.

We agree that, for GB electricity wholesale market, there are areas where there has been a decline in trading, but believe that the overall picture is one of increased trading and increased liquidity.

In analysing various forms of trading within the market, Ofgem's limited use of comparators risks spurious conclusions. For example, the inference from Ofgem's Table 7 and the supporting commentary is that the French market, a market with undesirably low levels of liquidity, is a model to be followed to support trading along the forward curve. Given Ofgem's comment, that while "churn in GB is higher than in France it remains significantly lower than in Germany and the Nordic area"[5], comparisons should be against markets where the desired higher levels of liquidity are present, i.e. Germany and the Nord Pool, not France, with its lower levels of liquidity.

Metric 5 – Availability of financial Derivatives

We recognise Ofgem's observation that "the current availability of financial products remains low but there are plans for new product development"[6]. The further development of financial products for the GB electricity wholesale market should have a positive impact.

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[4] Ofgem GB wholesale electricity liquidity: summer paragraph 3.29
[5] Ofgem GB wholesale electricity liquidity: summer paragraph 3.8
[6] Ofgem GB wholesale electricity liquidity: summer paragraph Table 11 Metric 5

For a competitive wholesale market to continue developing, it is important that market participants have a choice of mechanisms through which they can carry out their trading, including the trading of financial products. However, the development of such mechanisms, if they are to be successful, needs to be suitable for the particular wholesale market. When considering introducing new mechanisms, care needs to be taken to avoid imposing mechanisms that could have negative effects on market liquidity, such as mandatory requirements on physical players to undertake the role of market maker for financial products. Forcing parties to undertake commercial transactions that they would not ordinarily wish to enter into will expose them to greater levels of financial risk than they believe are appropriate. Assuming that efficient financial markets tend to allocate risks to those best able to manage those risks; then any misallocation of risk will reduce market efficiency. Therefore, parties need to be free to use financial products to match their portfolio needs and the level of risk that they are comfortable with.

Metric 6 - Participation by banks / other financial institutions on trading platforms

We agree with Ofgem's observation that "current participation [by banks / other financial institutions on trading platforms] is lower than in other highly liquid electricity markets, but could provide a reasonable base for growth in forward trading over time"[7]. However, our understanding is that it is only the German market and the Nord Pool that form the "other highly liquid electricity markets".

Group 3 metrics - Meeting independent suppliers' and others' wholesale requirements (supporting retail and broader contestability) (Metrics 7 to 11)

In relation to the Group 3 Metrics, we remain concerned that the majority of these metrics, and Ofgem's observations within them, appear to be based on the assumption that the wholesale market is suitable for all players regardless of size. As we explained in our April 2010 response to Ofgem's "Liquidity Proposals for the GB wholesale electricity market consultation paper", any actions to support small independent suppliers based on improving liquidity in the GB electricity wholesale market is unlikely to increase participation by such players.

The nature of wholesale markets is that they trade in large standard products. Such trading is usually impracticable for players who want to procure small volumes and/ or bespoke products. Having large standard products supports efficient trading and thus market liquidity. Introducing distortion to the GB wholesale electricity market, such as specifying artificially small clip sizes, to support players who would not normally be expected to trade in such a market, because of their small procurement requirements, reduces market efficiency and is likely to reduce overall liquidity.

While we believe that direct wholesale market participation by certain players, who want to procure small volumes and or bespoke products, is often not practicable, we recognise

[7] Ofgem GB wholesale electricity liquidity: summer Table11 page 27

the desire for mechanisms that support such players being able to access the benefits of a liquid wholesale market and thus better compete in the supply market. However, simply increasing the range of products available in a market is unlikely to attract many new participants. The UK gas market and the German power market offer fewer products than the GB electricity wholesale market, yet both have a greater number and diversity of participants, as well as having higher levels of liquidity. Products to help attract certain types of players need to be targeted to their needs. That is why we believe the development of voluntary volume aggregating arrangements operating outside of the main wholesale market, to support suppliers who wish to trade in small clip sizes or have small capital value, warrants further consideration for the GB electricity market.

Question 2: Do you have any comment on the level of improvement in the metrics that would make a significant difference for market participants?

General

When considering levels of improvement, Ofgem needs to factor in the effects of externalities, such as the general economic climate, the recent falls in electricity demand, the current uncertainty over the future regulatory environment for financial products and the increasing influence of gas on the GB electricity wholesale market. Failure to do this may result in erroneous conclusions about the GB electricity wholesale traded market's fundamentals.

It should also be remembered that that liquidity is only one indicator of a healthy competitive traded market. The GB electricity market is often cited as one of the world's most competitive electricity markets. A drive focused on raising liquidity levels and supporting small independent players in the wholesale traded market must not be at the cost of consumers, through a fall in the overall competitive nature of the GB electricity markets.

Group 1 and Group 2 metrics

We doubt that there is an absolute level of improvement in the metrics that would make a significant difference for market participants, although a general rise from the current levels of liquidity would obviously be desirable. Improvements in different metrics will have different levels of significance for different players.

As Ofgem explains, "there are various future developments that impact the medium run outlook for churn in the wholesale electricity market, and broadly point in a positive direction"[8]. We agree that market coupling through the BritNed interconnector should have a positive impact on liquidity in 2011. While there are already physical connections between the GB electricity market and other electricity markets, they are to markets, France and Ireland, which have much lower levels of liquidity than the GB electricity wholesale market. Connection to the Netherlands will be to a market that, while having lower levels of liquidity than the GB wholesale electricity market, has higher levels of

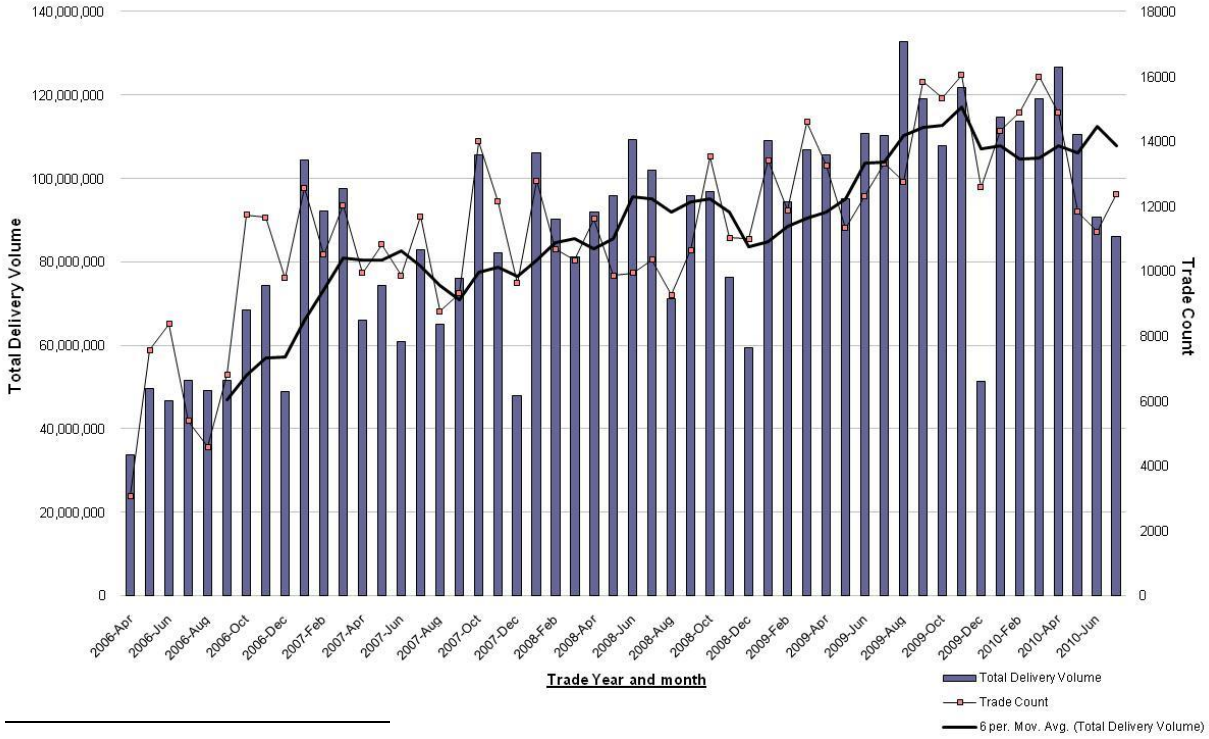
[8] Ofgem GB wholesale electricity liquidity: summer paragraph 3.11

liquidity than the two markets currently connected to the GB wholesale electricity market, suggesting a positive effect for the GB electricity wholesale market. With this development anticipated, the end of 2010 would seem to be a premature time to conclude that industry led initiatives will not deliver the required improvements in liquidity.

It is important that maximum benefit for liquidity is secured from the commissioning of the BritNed interconnector. The day-ahead auctions associated with use of the BritNed interconnector present an opportunity to facilitate a concentrating of day-ahead trading, and thus the creation of a credible index. However, this will only be achieved if there is coordination between the various interested parties involved in facilitating these auctions. Ofgem's participation in such coordination would be very helpful.

While Ofgem has identified areas that give concern, it comments that it is clear that "there are a number of positive developments, most notably that overall churn has been increasing since 2005"[9]. However, as shown in Figure 1 below, there are significant fluctuations around the general trend in the volume of trading; indeed this summer has seen trading at levels below the general trend and the projected growth we suggested in our April 2010 response to Ofgem's "Liquidity Proposals for the GB wholesale electricity market". It is too early to speculate as to what is causing the lower than expected levels of trading or for how long this will continue. Any decisions on the future of the market need to be based on a thorough understanding as to why there has been such a development. Ofgem's next formal assessment of the market's performance will be an ideal time to review what factors influenced liquidity during 2010.

Figure 1



[9] Ofgem GB wholesale electricity liquidity: summer summary, Current market performance, page 2

Group 3 metrics

Group 3 metrics seem to be trying to support suppliers who wish to trade in small clip sizes or having small capital value. It is difficult to see how, through natural competitive pressures, any significant improvements in support to suppliers who wish to trade in small clip sizes or having small capital value will appear within the trading activities of the GB electricity wholesale market. If a wholesale traded market is not suitable for players wishing to trade very small volumes or having small capital value, then improvements for these potential participants will probably be because of increased artificial distortion to the market.

If it is Ofgem's desire to support players wishing to trade very small volumes or having small capital value, then we again recommend that Ofgem looks at mechanisms, in particular voluntary volume aggregating arrangements operating outside of the main wholesale market, which would allow small suppliers to procure product in clip sizes smaller than available in the wholesale market. We described such mechanisms in our April 2010 response to Ofgem's "Liquidity Proposals for the GB wholesale electricity market". Obviously such interventions would carry significant risks. Consequently there would need to be some very tight controls and limits if such arrangements were to be introduced without disproportionate discrimination against existing players, or placing them, or the market itself, at significant financial risk. Ofgem's next formal assessment of the market's performance would be an ideal opportunity for evaluating if such mechanisms are worth developing for the GB electricity market.

Appendix 1

Metrics		Performance
Group 1 metrics - High volumes in standard products		
1	Aggregate churn: volumes traded across all products / GB physical consumption	Strong improvement in overall levels of churn, with churn forecast to rise to five in 2010. However, churn remains below levels in the most liquid wholesale electricity markets.
2	Bid-offer spreads for range of standard products	Widening of spread for products further along the curve although some narrowing for products closer to delivery.
3	Use of platforms which promote price transparency	Limited exchange based trading; slight improvement in recent years but well below other markets. N2EX trading provides some positive signs.
Group 2 metrics - The availability of key longer dated products (including financial derivatives)		
4	Volume of trade along the forward curve	The overall picture is mixed. Decline in baseload products traded further out along the curve, but an improvement in peak and off-peak volumes. Peak volumes further out are lower than levels in other markets.
5	Availability of financial derivatives	The current availability of financial products remains low but there are plans for new product development.
6	Participation by banks / other financial institutions on trading platforms	Current participation is lower than in other highly liquid electricity markets, but could provide a reasonable base for growth in forward trading over time.
Group 3 metrics - Meeting independent suppliers' and others' wholesale requirements (supporting retail and broader contestability)		
7	Diversity of products	Wide range of products available in the GB market but trade concentrated in a few products.
8	Number of counterparties active in the market providing hedging offers to small / independent suppliers	Some reports of an increase in the number of entities offering hedging services but not observed by all parties.
9	Participation by small / independent market participants on trading places	Small/independent suppliers do not utilise exchanges often, largely due to credit issues. No small supplier has joined the N2EX as yet.
10	Availability of suitable products with small clip sizes	The minimum clip size of products traded in GB has not changed over the past few years and remains above some other markets.
11	Feedback from a sample of small / independent suppliers, potential entrants, large energy users, and independent generators	Range of messages, but widespread criticism of longer term liquidity.