

**Response by European Energy Exchange AG (EEX)**

to the

**Consultation by Ofgem on  
GB wholesales electricity market liquidity:  
summer 2010 assessment**

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## 1. Introduction

European Energy Exchange AG (EEX) welcomes Ofgem's initiative to improve the liquidity of the GB wholesale electricity market and appreciates the opportunity to take part in the consultation.

EEX's response is divided in two parts: at first we make some general comments on liquidity, e.g. the relevance for the quality of a market and the competition as well as factors to improve liquidity. Secondly we answer Ofgem's questions asked in the consultation document.

### About EEX

EEX is a leading energy exchange in Europe and operates market platforms for trading in power, natural gas, emission rights and coal. To this end, EEX relies on an open business model which generates flexibility and market coverage and, thus, higher liquidity through targeted spin-offs and partnerships. Through this systematic expansion of co-operations, EEX makes a decisive contribution to the integration of European energy markets. EEX Group also includes European Commodity Clearing AG (ECC), the central clearing house for energy and energy-related products in Europe.

## 2. General comments on liquidity

Liquidity is the ability to buy or sell a product quickly without causing a significant change in its price and without causing significant transaction cost. A key feature of a liquid market is that it has a large number of buyers and sellers willing to transact at all times. Liquid markets provide investment signals to market participants and reduce the possibility for parties to manipulate prices. Lack of liquidity may, therefore, decrease the efficiency of wholesale markets and reduce competition between industry parties. There are a number of measures that could increase liquidity of wholesale power markets:

- **Good level of interconnection with neighbouring markets**

A higher degree of physical interconnection between markets is likely to lead to an increase in market activity and larger number of (active) trading participants compared to that of isolated markets. Physical interconnection between two markets means that all participants in each market have some interest in market prices on both sides of the interconnection. Further, a number of participants are likely to have direct exposure to prices on both sides of interconnection. Consequently, an increasing number of trading participants is likely to lead to a higher overall level of trading activity.

- **Great participation from the demand side**

Another key factor for improving liquidity in less developed markets is to get demand side buy-in from physical consumers of electricity, since those players are able to provide a reliable liquidity basis which may attract further participants. The same effect may be reached through market coupling initiatives which physically link markets of neighbouring countries, if at least one of the coupled markets provides high trading volumes and sufficient capacities for physical energy flows between market areas are available.

- **Accepted reliable prices / indices**

The development of indices could provide a potential point of reference for transacting. The creation of a trustworthy index is essential to build a financial power market.

- **Continuous trading as an option to increase liquidity**

Independent gas-fired generators generally hedge risks by almost simultaneous selling of power and buying of natural gas in order to lock in revenues and costs at the same time.

In an auction, there is a delay between the time of placing bids / offers and the time at which market results are published. If an auction is used for trading at the electricity market, the price of natural gas can change markedly during the time required for the auction. If auctions are used at both markets but at different times of a trading day, the situation is even worse, since the participant is always committed to selling power or buying natural gas at the prices submitted into the auction. A continuous market (as exists at present) allows gas purchases in line with power sales in a more dynamic manner.

- **Transparency**

Transparency is vital for energy markets by creating and strengthening trust to the market and the public as well as supporting the market supervision and regulatory authorities. Overall, transparency makes energy trading understandable and comprehensible and encourages new entry from producers, shippers and suppliers, thereby increasing competition. Greater information availability also improves participant's understanding of markets and their ability to predict future developments, thus reducing the uncertainty involved in market participation. It also reduces the information advantages that incumbents typically enjoy.

- **Voluntary market making on the exchange**

An independent (voluntary) market making on the exchange with obligations to ensure a relatively tight bid-offer spread in continuous trading may play a very important role in facilitating liquidity on already established trading platforms, particularly for the longer-term forward curve.

- **Standardisation and harmonisation**

Basically, an intra- and inter-commodity harmonisation of different national markets affects market rules like trading times and admission procedures, product specification, and trading and clearing systems. Through harmonisation of markets, it becomes easier for market participants already active in one market to actively participate in other markets. Additionally, costs market participants are facing for trading and clearing services are cut down since technical and organisational complexity are reduced and benefits like cross-margining can be exploited. Hence through harmonisation of markets, mature markets help to develop liquidity in markets which do not show high trading volumes today. Following aspects, as clip size, trading periods, currencies, units, balancing system and charges should be harmonized across different power markets.

- **As little as possible regulatory interventions**

Direct trading obligation is not an appropriate solution as it causes the risk of monopolistic structures. Also mandatory clearing through a clearing house (CCP) is not an appropriate approach for energy market trading. Markets are suitable for new forms of hedging and collateral without regulatory intervention.

Mandatory auctions, self-supply restrictions and other regulatory interventions would not be beneficial to the market. These instruments could increase regulatory risks and could potentially scare away new participants and harm liquidity. A better alternative is voluntary market making as described above

- **Increased role of renewable energies in power generation**

The expected expansion of generation of renewable energies and their integration in existing market infrastructures could lead to increasing trading volumes.

Fluctuating wind power could provide a significant fraction of both total installed generation capacity and total electricity generation. As a consequence, existing close interdependencies between electricity and natural gas markets with large amounts of gas-fired power plants could decrease. This will lead to electricity prices becoming more independent from natural gas prices in the UK, hence increasing the need for a transparent electricity market, but also trusted reference price for power in the future. Offering transparency about price formulation and market data (e. g. similar to the transparency website of EEX: [www.transparency.eex.com](http://www.transparency.eex.com)) will become a crucial element in the development of the electricity market.

It should be also considered that the liquidity criterion on its own is not sufficient to judge the quality of a market. Following criteria could be also taken into consideration:

- Number of market participants: buyers and sellers willing to transact at all times (active market participants).
- Market depth with sufficient volumes of pending orders on both sides, preventing large orders from moving the price.
- Bid-offer spread in a liquid market should be fairly small in relation to the market price so that market participants can buy and sell without incurring significant transaction costs.
- Length of time that spreads are available and not just how tight the spreads are.
- Number of trades per day.
- Range of products offered: by maturity of contract, clip size, shape etc.
- Open interest in derivatives trading.

### 3. Answers to questions

#### 3.1. Proposed metrics

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

#### High volumes in standard products

*Aggregate churn*

We agree with the outlined metric.

### *Bid-offer spreads*

We agree with the outlined metric.

### *Use of platforms which promote price transparency*

The used measures could narrow the perspective. The relation of exchange trade to the total trade is not necessarily an expression of liquidity. For example, exchanges with relative low percentage of total trade could have absolutely high trading volumes. In addition, experts generally agree that the percentage of exchange trading is less important for a price reference than accessibility to the market, non-discrimination and transparency about the pricing mechanism. Share of the exchange-traded volumes in total power consumption has also a limited eligibility, especially for the spot market. Spot markets are typically used for short term portfolio optimisation and for daily balancing of supply and demand needs as a direct consequence of technical constraints like non-storability of power. Considering the volatility of volumes and prices on the one hand and the prerequisite of security of supply on the other hand it appears questionable to trade the vast quantities via spot markets.

We propose the use of the following additional alternative metrics/measures:

- Number of trades per day.
- Number of active participants.

## **The availability of longer dated products (including financial derivatives)**

### *Volume of trade along the forward curve*

The view to volume of trade along the forward curve to 13-24 months ahead or more seems to be not sufficient. Derivatives products with shorter maturity (e.g. weeks, months and quarters) should be considered as well.

### *Availability of financial derivatives*

Focusing only on financial derivatives might not consider the whole picture of the market. Physical settled derivatives may also be taken into consideration.

### *Participation by banks / other financial institutions on trading platforms*

Participation of financial players (banks, hedge funds, financial institutions etc.) is crucial for the development of liquid markets. Financial players, attracted by price movements and volatility are increasing overall rate of churn and supporting market depth.

## **Meeting independent suppliers´ and others´ wholesales requirements (supporting retail and broader contestability)**

### *Diversity of products*

Diversity of products offered on the exchange or OTC markets is less relevant for market development and liquidity. Further, large number of different products offered may even split the liquidity across different products. From this point of view, it seems that a dedicated number of products (financial, physical), which are standardised and harmonised with Continental European power markets is crucial for development of liquid power market in GB.

### *Number of counterparties active in the market providing hedging offers to small / independent suppliers*

Even if prices quoted and bid-offer spreads are tight it is often the case when bids are lifted, if there are not enough supporting members behind it, thereby limiting the tradable volumes. Hence, a sufficient number of active market participants, which are willing to transact at all times is a very important criterion of market liquidity.

### *Participation of small / independent market participants on trading places*

Currently, a majority of small trading participants (and new independent entrants) stay away from active participation in power trading, hence preventing market depth. Possible reasons for lack of participation are:

- Concern that markets are controlled and dominated by vertical integrated companies.
- Setting up voluntary trading arrangements (Grid Trade Master Agreement) with different counterparties is very time-consuming.
- High credit and collateral requirements, in particular for long curve on existing commodity exchanges (at the same time not only exchange trading requires posting of margins, it is also usually required in the OTC market).

In addition to the direct participation of small / independent market participants on trading places these entities can also use intermediaries to use trading services. Service providers which bundle the interest of participants not able or prepared to act direct on the market should be considered as well.

### *Availability of suitable products with small clip sizes*

Small clip sizes for small trading participants might be considered. At the same time regarding their small contribution to overall trading volumes, it is unlikely that small clip

sizes will be a crucial element to increase market liquidity. Hence, an appropriate compromise should be found.

*Feedback from a sample of small / independent suppliers, potential entrants, large energy users, and independent generators*

It is understood that a feedback from individual group of trading participants is necessary; more important is, however, a feedback of overall market.

### 3.2. Preliminary assessment

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

Yes, we agree with the assessment of the metrics in this chapter.

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

As already mentioned above, transparency is basic for energy markets and should be considered in the metrics in an appropriate way.

Transparency creates and strengthens trust in the energy markets as a prerequisite for the entry of new market participants, the increase of liquidity and strengthening of competition. In this respect, market transparency would be an effective tool for preventing possible market abuse.

Market transparency should ensure that market prices reflect the true market value. In addition, market transparency creates the same level playing field for all market actors and reduces the possibility of market price influence by single market participants.

We recommend publishing accumulated transparency information on a regular basis on a centralised web-based platform with a public access. It is important to ensure that independent bodies (without direct commercial interest in transparency information and not suppliers of fundamental data) are dedicated and qualified as publishers of such information. Energy exchanges, being supervised by energy and/or financial authorities may act as neutral bodies, which have natural interest and competence to facilitate the accessibility of such information.



Implemented internet based platforms by Energy Exchanges currently ensure pre-trade transparency of fundamentals that can influence the price formation and power balance in the short and longer time frame (e.g. via planned/unplanned outages for production, consumption and grid (interconnector) per individual unit and/or aggregated) as well as post-trade transparency (e.g. publication of information as close to real-time) and provide market surveillance.

Being provider of fundamental data since 2006, EEX continuously expanded its transparency initiative. In 2009 EEX established in cooperation with German TSOs a separated transparency platform ("Transparency in Energy Markets", available to the public at [www.transparency.eex.com](http://www.transparency.eex.com)), which accumulates market-relevant generation data and gained positiv feedback from market participants and supervision authorities.

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