GB Wholesale Market Liquidity – summer 2010 assessment

Submission by International Power plc
9th September 2010

(I) About International Power

IPR welcomes the opportunity to contribute Ofgem's summer 2010 assessment of GB wholesale market liquidity.

International Power plc (IPR) is a global independent power generation company with interests in over 32,000 MW of generation capacity in 21 countries. This includes approximately 5000 MW of plant in the UK market where, in partnership with Mitsui & Co., it owns and operates the coal fired station at Rugeley, Deeside Power CCGT, Saltend Cogeneration Plant in Hull, First Hydro Pumped Storage Stations at Dinorwig and Ffestiniog in North Wales, and Indian Queens peaking plant in Cornwall; the company also has a share in Derwent Cogeneration plant. These assets represent a 7% market share, making IPR one of the country's largest independent power producers.

(II) Summary key points

Ofgem's proposed assessment seems very thorough but with too much emphasis being given to contestability. The major focus should be on where liquidity issues in the wholesale market are impacting companies' ability to hedge their portfolios. If changes are to be made to improve the circumstances of small suppliers, they should be structured such that they also improve the market more generally.

We note that Ofgem forecasts a churn level for 2010 of around 5. Having analysed trading data we conclude that wholesale volumes remain increasingly concentrated in the short term markets and less in the longer term markets than in recent years. The market is reasonably content with liquidity in the short term, but liquidity in the longer term markets still needs to improve. We are concerned that the focus on overall churn levels is masking the real problem; the lack of longer term liquidity and the depth of trading in non-baseload products.

Ofgem needs to be careful in placing too much emphasis on some of the metrics and in intervening without both sides of the 'story'. Under metric 8 for example, practical issues such as credit may explain why discussions do not always result in pricing offers even being made.

Ofgem intends to undertake a further assessment by the end of the year. For some of the metrics (use of platforms and financial derivatives) this timescale may be too short to show any change. Ofgem should be cautious in intervening before these markets have had the chance to evolve.

(III) Consultation questions

Question 2.1: Do you agree that the proposed framework provides an adequate range of evidence for assessing market liquidity?

With eleven metrics, Ofgem appears to be thorough in its assessment of market liquidity although we note that five of these metrics focus on meeting the needs of independent smaller market participants. Market contestability and liquidity are two separate issues; it should not be assumed that adapting the market to meet the needs of smaller participants will improve liquidity. The major focus should be on where liquidity issues in the wholesale market are impacting companies' ability to hedge their portfolios.

Therefore, whilst we agree with the distinction drawn in some of the metrics, we are concerned that too much emphasis will be given to some areas relating to small suppliers at the expense of addressing wholesale liquidity in the long term segment of the electricity traded market.

Metric 1 - this metric measures aggregate churn. There needs to be a deeper assessment of churn of different products and from different parts of the market over all trading timescales e.g. an assessment of the level of churn in off peak products and the depth of this market from the long term to the prompt. Metric 4 could be expanded to capture this data.

Metric 4 is a very important metric as it measures forward trading along the curve. Given the general degree of satisfaction with prompt trading and its influence on the headline aggregate churn level, metric 4 should be promoted in importance since it is here that liquidity needs to improve.

Metric 8 examines hedging offers to small independent suppliers. IPR has from time to time been approached by smaller suppliers and has some resulting transaction history. However, practical issues such as credit may explain why discussions do not always result in pricing offers even being made. Ofgem therefore needs to be careful not to place undue emphasis on this metric – negotiations are by definition bilateral and both parties have a role to play in exploring whether offers/bids are made, whether terms can be agreed, and ultimately whether prices are acceptable to both parties.

Metric 11 - this metric focuses on providing qualitative feedback on contestability. To provide a counterbalance to the quantitative metrics, metric 11 should also encompass liquidity. This would allow all market participants to give a view on changes in liquidity separate from Ofgem's analysis.

Group 3 - The metrics suggested here are biased towards inclusion of small suppliers needs without any adequate provision for assessing whether these companies are trying to improve their volume in the wholesale market in the next few months. A lack of increase in volumes transacted by small suppliers in the next few months does not necessarily reflect on the inadequacies of the wholesale market. The review considers at length how the wholesale market could be improved to help small suppliers but this could potentially fragment the market as market clip sizes ,offerings and products are changed just to focus on their specific needs. This would also distract from the wider liquidity issues.

There will always be a cost for joining the market and larger companies will have the economies of scale and financing advantages over smaller companies, and would always have to be mindful of the risk inherent in trading with less capitalized companies. IPR does not support modifying the market if it is to the detriment of the larger participants who provide the vast majority of the liquidity. If changes are to be made to improve the circumstances of small suppliers, they should be structured such that they also improve the market more generally.

Question 3.1: Do you agree with the assessment of the metrics in this chapter?

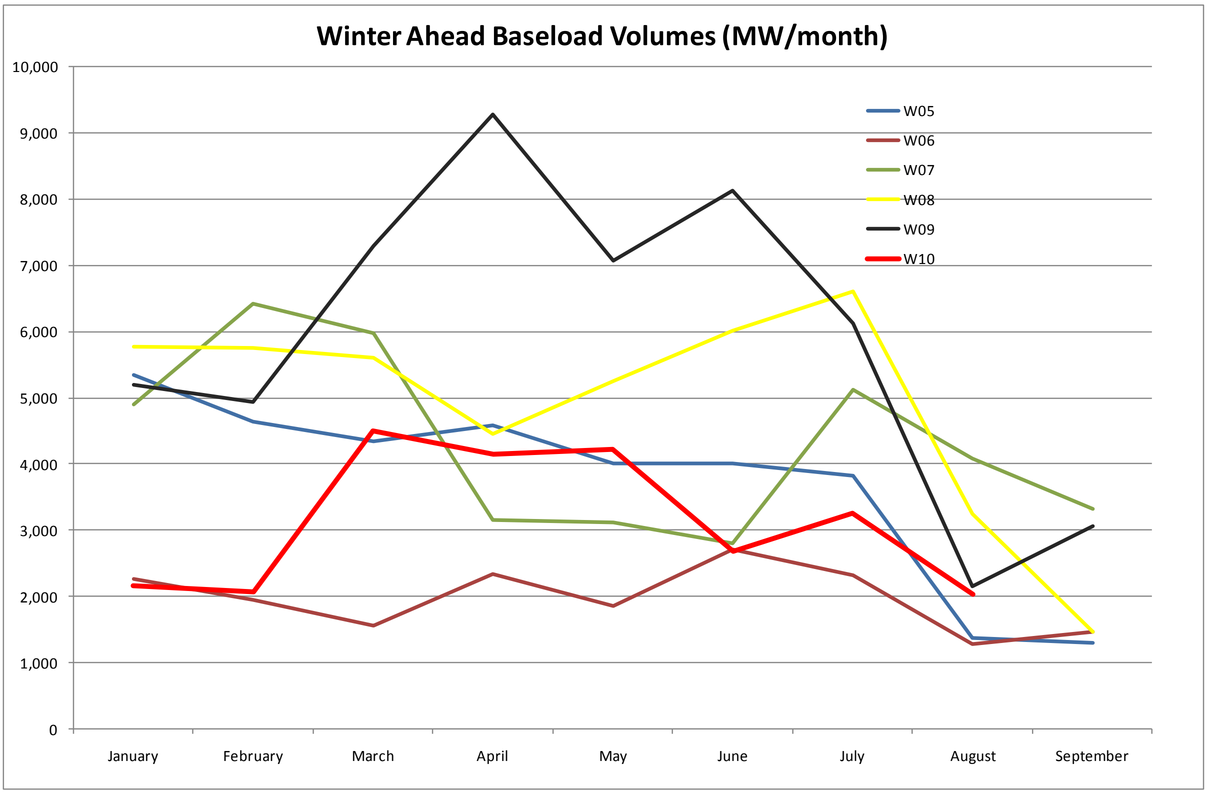
Metric 1 – Aggregate churn

We agree that measuring churn provides a useful indicator of overall liquidity but believe that this headline number needs to be treated with caution.

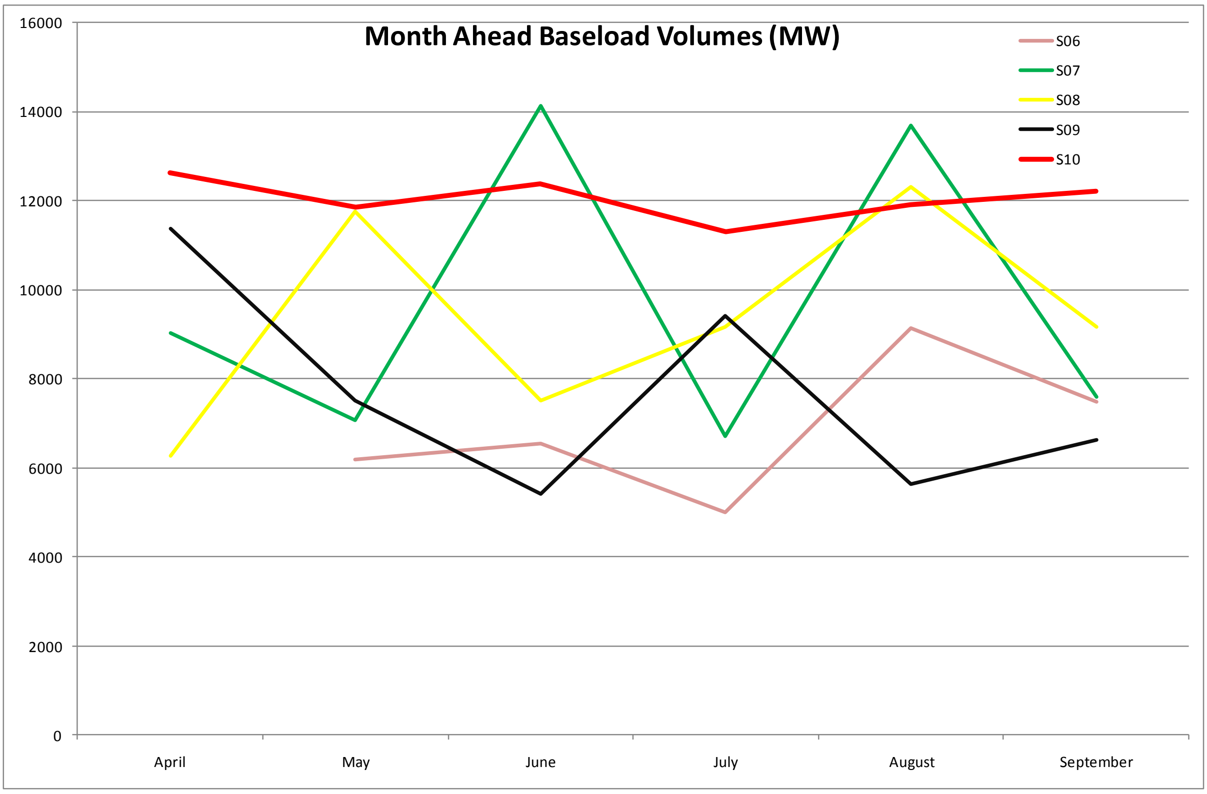
We were initially surprised that Ofgem is forecasting a churn level of 5 for 2010 as this is not consistent with our observations on the market during 2010. We have collated our own data to establish whether or not the improvement is real.

The graphs below provide some useful insights:

1. Trading volumes for winter 2010ahead baseload are lower than any of the last 3 years.



2. There are some signs that short term trading volumes have increased



We conclude that wholesale volumes remain increasingly concentrated in the short term markets and less in the longer term markets than in recent years. Whilst there has been a clear pick up in month ahead trading compared to previous years, we do not believe that it is reflective of a sustainable structural change in market liquidity; it is more a need to sell volume in the short term in the face of falling wholesale prices across the curve. Therefore, whilst the level of churn overall may be increasing, it seems to be entirely due to trading in the short term and prompt market.

The market is generally content with short term liquidity, it is the ability to trade longer term that is generally recognized as insufficient. Ofgem needs to be cautious in using its headline churn number as it masks the real problem; the lack of longer term liquidity and the depth of trading in non baseload products.

Metric 2 – Bid-offer spreads

We agree that bid-offer spreads have widened on seasonal products. This is not just 13-24 months ahead but also within year (i.e. season ahead).

Prompts spreads have narrowed as there has been a greater necessity to contract those volumes and shapes which were not transacted at, say, season ahead due to illiquidity and unattractive prices.

Metric 3 – Use of platforms

N2EX is still at an early stage of gaining acceptance from the market, but the increasing trend in volumes cleared from the OTC market is welcomed. However, given the complexity and length of time needed to join the exchange, there are unlikely to be results in the next six months which could be extrapolated for meaningful analysis. Ofgem should delay any interventions in this area until the N2EX platform has evolved.

Whilst there is growing involvement in the cleared OTC market it is difficult to see to what extent there is participation in the day ahead auction There therefore needs to be greater clarity of the depth of participation in the auction to ensure that it is reflective of a broader market involvement; especially if it is to be considered as a viable source for a market reflective index.

IPR does not see the N2EX gaining wide support from industry participants as an index until it can be shown that it reflects participation by the majority of the market with volumes to match. To better understand the extent of participation and to aid debate on its acceptability as the basis of an index, we would like to see analysis of market concentration for the N2EX auction similar to Ofgem's table 6 on market share of top five participants for the OTC market.

Metric 4 –Volume of trading along the forward curve

We agree that there has been no improvement in liquidity along the curve and in particular in non baseload products. These are only sporadically quoted on the curve with quite often only either a bid or an offer in very small size and no depth behind the headline price. Indeed it is often difficult to get products other than baseload or peaks quoted right down to month or week ahead. Where peaks and off-peaks are traded they may do so in good volume for a couple of days then there may be no interest for the next few weeks; there is certainly no consistency in volumes from one month to the next.

Ofgem's analysis shows an appreciable increase in off peak trading year ahead. We have looked at our own data and conclude there have been a couple of days of large volumes which have distorted patterns where generally the non baseload volumes are very low in comparison to baseload transactions. The off peak improvement has not been on a consistent basis.

There needs to be a deeper assessment of churn of different products and from different parts of the market over all trading timescales e.g. an assessment of the level of churn in off peak products and the depth of this market from the long term to the prompt. Metric 4 could be expanded to capture this data.

Metric 5 – Availability of financial derivatives

Whilst we fully support the trading in financial derivatives, these will only take off when an index has been agreed and is generally accepted. The market is not at this stage yet and is unlikely to make such a large leap in the next few months. Even with an established index there is no reason why financial trading would necessarily replace physical volumes if the cost of credit is materially higher.

Metric 9 – Participation of small/independent market participants on trading places

So far no small suppliers have joined N2EX where they could trade in small volumes on the day ahead auction. Is it because cost of joining, capital requirements and margining are more onerous than terms offered by larger players directly in wholesale market? The reasons for this require further investigation.

Question3. 2: Do you have any comment on the level of improvement in the metrics that would make a significant difference for market participants?

IPR would like to see a significant improvement in the longer term market liquidity particularly for peak and off peak products as these markets are particularly thin. The need for improvement also extends right down to the short term; it is often difficult to get products other than baseload or peaks quoted right down to month or even week ahead.

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