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GB wholesale electricity market liquidity: summer 2010 assessment

Dear Robert,

Thank you for the opportunity to comment on the above consultation. This response is provided on behalf of the RWE group of companies, including RWE Npower plc, RWE Supply and Trading GmbH and RWE Innogy GmbH.

We welcome the latest Ofgem assessment of liquidity and the proposed framework of indicators to evaluate the effectiveness of wholesale markets. The proposed framework is certainly a better basis for evaluation than the crude measures of "churn" that featured in previous discussions. We believe there are still some pitfalls to avoid, however, which are discussed below. Comments on the individual items are in the attached Annex.

In general, when using metrics, Ofgem should be careful not to draw inappropriate comparisons. For example, the existence of a large number of small suppliers and higher levels of liquidity in other countries is not indicative of a high level of retail competition. In both the Nordic markets and in Germany the majority of the very numerous wholesale market participants are ex-monopoly distribution/supply businesses which have been able to maintain their market share. Rather than being indicative of vigorous competition this is, in fact, the result of a competitive and regulatory framework which is not yet mature. For example, in these Member States, distribution and supply have only been legally unbundled since 2005-06.

We would also like to reiterate our doubts that liquidity is the most important barrier to new suppliers entering the market. There are at least two areas where there are larger barriers to entry.

Firstly, some potential new entrants do not have sufficiently strong balance sheets to deal with the risks associated with running an energy supply business. This problem could be resolved since several of the so-called 'small' suppliers are backed by much larger groups such as DONG (Haven), International Power (Opus, IPM) and Marubeni Corporation (Smartest). The low level of retail margins in the last few years has not helped small suppliers in this regard.

A second major barrier is the considerable cost associated with meeting regulatory requirements. Many of these have been imposed by government policy and are embodied in supply licence conditions. Small suppliers have recently highlighted the costs associated with running a supply business above the 50,000 threshold. Further simplification of the regulatory framework across the board would encourage entry and the growth of such companies.

Higher levels of liquidity are, however, desirable. As you know RWE has been a major supporter of efforts, through N2EX, to increase liquidity and reduce the costs of trading. The exchange now has 17 Members and volumes continue to grow, particularly in the prompt market where values in excess of 100MWh/day have been recorded recently. Meanwhile auction volumes will get a significant boost from the introduction of market coupling on UK-continental interconnectors. Another possibility being discussed to improve volumes is to make the auction earlier in the day.

Our general expectation is that liquidity is set to continue its increase over the years ahead. This will provide ample opportunity for new supply businesses to enter the market in the coming years provided that they are sufficiently well capitalised and are prepared for the considerable regulatory engagement that goes with being an energy supplier.

We restate our misgivings about all the potential interventions put forward by Ofgem in its February document, in that the measures being put forward will conflict with current efforts to increase liquidity.

We provide specific comments in the attached annex.

Yours sincerely

Alan McAdam
Economic Regulation

Attachments – Annex 1

Annex 1 Comments on the proposed framework and Ofgem's assessment

In general we believe the list of indicators put forward by Ofgem is reasonable although it could usefully be shortened and simplified. There are too many indicators in the third part of the framework relating to "meeting independent suppliers needs". As discussed above and in previous responses, these "needs" are often outside the scope of the liquidity discussion. Overall we support Ofgem's approach to take a holistic view of these indicators rather than setting rigid targets.

Volumes in standard products

1.High volumes in standard products	A simple "churn" indicator is probably a necessary indicator although, as noted above, crude comparisons with other countries and markets are not always helpful. We agree with the assessment that liquidity (as measured by churn) has significantly increased since 2006. It is now around 5x the underlying consumed volume which is reasonably healthy and roughly twice the 2006 level. We believe further improvement will occur and that this should be allowed to happen spontaneously.
2. Bid offer spread for a range of standard products	Bid-offer spread on standard products is also a relevant metric and can be analysed alongside the churn figures. Again, crude comparisons may not always be helpful. Lower spreads will occur as financial products develop and more players enter the market. So there is some overlap with item 6. We agree that lower bid-offer spreads for standard products would reduce costs for all market participants and improve the functioning of wholesale markets. However we do not believe there should be any particular target and would oppose any measures to seek to regulate spreads directly. This would be a big disincentive for financial players.
3. Use of platforms that promote transparency	We support the view that a greater volume traded on transparent platforms will increase the reliability of reference prices. This is particularly true for the spot and prompt markets as it will lead to more traded financial products being developed. As we suggested in our previous response, we would like to see the majority of the 200GWh/day which is currently traded on a day-ahead basis going through the cleared prompt trading with transparent prices, or through the daily auction. In the meantime a volume of 20GWh/day going through the auction would be enough to develop a reliable reference price for financial derivatives. We note that market coupling already implies an additional volume of up to 72GWh/day (3GW x 24 hours) being traded through day-ahead auctions.

	With respect to forward\future trading there needs to be competition between cleared exchange based trading and OTC. There is no benefit in favouring any particular form of trading for futures\forwards and smaller companies have indicated that they value the opportunity to trade OTC without the cost of clearing. However transparency could be improved with respect to prices, but we expect this to be provided under the market transparency and integrity framework currently being developed by DG Energy.

Availability of longer dated products

4. Volume of trading along the curve	It is reasonable to use this indicator but there are limits to how far term markets should be expected to develop. Not many markets are particularly liquid beyond two years, either in other countries or sectors. In any case, the volume of trading along the curve is only important to the extent that consumers are looking for fixed price contracts over several years. We believe there are only a few customers looking for such products (e.g. water companies). Such contracts raise significant credit issues. Having said this, trading along the forward curve needs to improve. We would like to see increasing levels of trade in baseload and peakload financial derivatives for the next 2-3 years, with financials lending themselves to such longer dated trading due to their different credit profile relative to physical transactions The uncertainty with respect to the CO2 auction process after 2012 continues to have a negative impact on liquidity for longer dated contracts, this is true for both physical and financial contracts.
5. Availability of financial derivatives	The availability of financial derivatives would indicate whether the market was producing reliable reference spot prices. However there is clearly some overlap between this indicator and item 3 above. We agree that the market for such products is, at present, poorly developed. We expect the greater transparency and credibility of spot reference prices, resulting from N2EX to encourage financial products further. Wider reforms to EU financial regulation could, however, undermine the development of a supporting financial derivatives market if, for example, capital charges and other obligations attach to derivatives – as opposed to physical trading.
6. Participation by banks / other financial institutions on trading platforms	Participation by banks and other financial players is not exclusive to longer dated products and this indicator may be better in the first section. It somewhat overlaps with the other indicators such as item 2. We would like to see a further increase in participants in N2EX from the current level of 17. As far as forward markets are concerned we believe there are already a sufficient number of participants.

Meeting independent market participants' requirements

7. Diversity of products	In general we agree with the assessment that a greater range of product availability would be desirable. However it is difficult to specify a particular target in terms of particular products or the HHI measure developed by Ofgem. However it would be wrong to expect the wholesale market to deliver highly tailored disaggregated or shaped products to all suppliers across all conceivable periods. The development of wholesale market liquidity – almost by definition – involves a focus on highly standardised products that broadly meet most participants needs most of the time, rather than specifications tailored to the needs of individual producers or retailers. Just as Brent Crude id traded despite a wide range of underlying quality specifications and delivery points, the liquidity of the UK gas, German power and Nordic power markets centres on a few basic products (baseload, peak, off-peak) with market participants using the short term markets, auctions etc. to manage the differences (or "basis") between the standard products and their own particular profiles and delivery points. (Some of which can also be managed with significantly less liquid instruments, e.g. The locational Contracts for Difference listed by Nordpool.) In UK power specifically, we do not expect longer dated shaped products to develop rapidly. With the generation market structure more fragmented than, for example, the 1990s, there is no natural match between the operational parameters of any individual generator's portfolio and particular daily shapes. For an individual producer to offer such a product would either require them to purchase from the other companies, to maintain plant in a warm state - or even running at stable export load - to provide the necessary ramping capability. In doing so, they are also likely to forgo the future flexibility to respond to market price signals closer to real time. This would not only be inefficient, environmentally wasteful and expensive but it would make the product less attractive to the potential counterparty. As a result longer dated shaped products would be less attractive for small suppliers than more flexible arrangements based on trading hourly products closer to real time. In general, we would expect a healthy wholesale market to be characterised by liquid forward markets across the curve for baseload, peakload and offpeak products. We would not expect EFA blocks to become liquid much before the month-ahead stage. We would expect hourly trading to be mainly at the prompt/day-ahead stage. This does not mean that the presence and emergence of more shaped products is not important, merely that we should look to the retail – rather than the wholesale markets – to

	provide them and, here it must be recognised that many customers already access shape – to half hourly detail – through existing retail offerings. With a competitive retail market, the additional cost of providing shape and covering forecast errors and imbalance risk is already relatively transparent and competitively priced. However, one of the main benefits of N2EX is to further improve the transparency and confidence in the resolution of hourly prices which should allow shape products to be even more keenly negotiated and priced.
8. No. of counterparties providing offers to small/independent suppliers	It does not seem sensible to distinguish between counterparties in general and those making offers to certain companies. If companies are trading they are, by definition, open to all. In any case we believe that all suppliers should be encouraged to participate directly in wholesale markets. We suggest this indicator should be merged with item 6.
9. Participation of small / independent players	This is a reasonable metric, although as discussed above, there are other much larger barriers to this occurring. The responses also suggest that some companies seem reluctant to participate in existing platforms, which is difficult to understand if the companies concerned are committed to building a sustainable energy supply business. We support the encouragement of independent suppliers and generators to use existing exchanges. We would like to see all licensed suppliers participating in day-ahead auctions and on cleared exchanges in some form.
10. Availability of suitable products with clip sizes	Availability of these products is a reasonable indicator. However, the volume of trade in small clip sizes will depend on item 9 above so we suggest this element is dropped.
11. Feedback from a sample of independent suppliers	We would expect Ofgem to be doing this as a matter of course. It is not, however, reasonable to include this as a “metric” in the analysis as it is not something that can be objectively measured. We suggest this is deleted from the “metrics” list.