Retail Market Review: Intervention to enhance liquidity in the GB power market

Response from the Chemical Industries Association

The Chemical Industries Association[1] welcomes the chance to respond to this key Ofgem consultation. Electricity costs are a significant part of our energy intensive members operating costs; we therefore welcome the focus on liquidity in the GB power market which is of grave concern to our members. Secure and competitive priced energy is essential to our membership, which compete in globally traded markets.

General remarks

We support Ofgem's goal to increase market liquidity - The CIA has previously stated its support for an obligation on the 'big six' power generators to aid market liquidity. Indeed any action that opens up the market and provides visibility of pricing and product structure is fully supported. Although appreciative of the continued work and investigation Ofgem are undertaking to improve the current situation, our members feel that the provisions as set out in the consultation document, do not go far enough to adequately address the problem.

Near term liquidity still remains a problem **-** There is general recognition that there have been some improvements to liquidity since Ofgem's last assessment. However we have had feedback from our members that improvements to day-ahead trading are still extremely limited on the GB power market. Indeed it has been highlighted that for some hours of the day, no trades are being made at all on exchanges. This presents a problem to large energy consumers as they will trade via OTC without the transparency of where the market actually lies; this is especially problematic if there has been an outage or unscheduled change in production. This problem is clearly not present for natural gas. We would ask Ofgem to continue to monitor, investigate and maintain the momentum in promoting useful liquidity in the near term electricity wholesale market.

Mandatory Auction- We have doubts as to whether a mandatory auction will deliver the appropriate goals of robust reference prices along the curve and adequate hedging products. There are also doubts as to whether Ofgem has appropriately stipulated adequate products and volumes to enable liquidity to increase. Whilst in favour of increased volumes being traded on a number of forward products, the mandatory auction as set out will only result in monthly auctions sold artificially outside of the market, leading to inadequate reference prices. Will this scheme alone provide the continuously traded market we are after? The large

[1] See appendix for further details on the Chemical Industry

timescales between monthly auctions will also lower confidence in the reference prices yielded.

We are disappointed that Mandatory Market Making is not being taken forward - When looking at other markets such as Belgium, and the Nordic areas run by Nord Pool, it is clear that a market maker has aided liquidity. As already stated we doubt whether the mandatory auction alone will provide a continuously traded market which our members are after. Our members feel that adequate reference prices could result from a market making mechanism. We would therefore ask Ofgem to continue to investigate the need for a market making mechanism as part of the package of proposals.

Unilateral increases in energy costs must be mitigated –We welcome Governments commitments to mitigate the unilateral UK cost increases our members will experience as the Electricity Market Reforms (EMR) are implemented. As part of this we are seeking further details on how the Government intends to reduce the impacts of future costs from FiT CfDs which could be considerable. We recognise the relationship between Ofgem’s work of further enhancing forward liquidity and robust forward reference prices that should result. The ability to cost effectively link CfD FiTs with robust prices should aid the administration of the scheme and help keep costs of the scheme down.

Our members need a recognised reference price - We have already discussed our members need for a recognised reference price and the additional benefits this may also bring as part of the EMR reforms. It is clear that increasing electricity liquidity is not easy, and that any liquidity reforms are going to take time to implement. In order to help promote liquidity we would encourage Ofgem to install interim steps to ensure that there is a properly recognised benchmark price for forward GB power markets. This could be a publically available database or a central publication to ensure that the transparency is there for the market. For example, the gas market was helped by the publication of a recognised day-ahead index by Heren. This then became the de facto standard for the market and aided its development. We would like to see a proposal from Ofgem that looks at publishing an index price whether it is the energy regulator or a third party.

Please find below CIA comments to the questions asked in which we have only responded where we think it appropriate;

Question 1: *Do you agree with the objectives we have identified?*

As raised in our general remarks the CIA agrees that interventions need to be introduced to increase liquidity in the GB power market.

Question 2: *Do you think there are other objectives we should be considering?*

The objectives as set out seem reasonable.

Question 3: *Do you agree with our views on market developments since summer 2011?*

There is general recognition that there have been some small improvements to liquidity since Ofgem's last assessment. However we have had feedback from our members that improvements to day-ahead trading are still extremely limited on the GB power market. Indeed it has been highlighted that for some hours of the day, no trades are being made at all on exchanges. This presents a problem to large energy consumers as they will trade via OTC without the transparency of where the market actually lies; this is especially problematic if there has been an outage or unscheduled change in production. This problem is clearly not present for natural gas. We would ask Ofgem to continue to monitor, investigate and maintain the momentum in promoting useful liquidity in the near term electricity wholesale market.

Question 4: *What specific further developments would be necessary to meet our objectives?*

We would ask Ofgem to continue to monitor, investigate and maintain the momentum in promoting useful liquidity in the near term electricity wholesale market.

Question 5: *Do you agree that objectives one and two are current priorities given market developments?*

As stated in our general remarks and answer to question 4, we feel that focus should also continue on the near term market.

Question 6: *Do you agree that the MA is the appropriate mechanism to meet our immediate objectives?*

Members have highlighted doubts as to whether a mandatory auction will deliver the appropriate goals of robust reference prices along the curve and adequate hedging products. There are also doubts as to whether Ofgem has appropriately stipulated adequate products and volumes to enable liquidity to increase. Whilst in favour of increased volumes being traded on a number of forward products, the mandatory auction as set out will only result in monthly auctions sold artificially outside of the market, leading to inadequate reference prices. We have concerns that this scheme alone will provide the continuously traded market we are after, the large timescales between auctions will also lower confidence in the reference prices yielded.

Question 7: *Do you agree that, at the present time, the other mechanisms identified would not be appropriate for Ofgem to pursue?*

When looking at other markets such as Belgium, and the Nordic areas run by Nord Pool, it is clear that a market maker has aided liquidity. As already stated we doubt whether the mandatory auction alone will provide a continuously traded market which our members are after. Our members feel that adequate reference prices could result from a market making mechanism. We would therefore ask Ofgem to continue to investigate the need for a market making mechanism as part of the package of proposals.

Question 8: *Do you agree with the key features of the MA we set out?*

There are doubts as to whether Ofgem has appropriately stipulated adequate products and volumes to enable liquidity to increase. Whilst in favour of increased volumes being traded on a number of forward products, the mandatory auction as set out will only result in monthly auctions sold artificially outside of the market, leading to inadequate reference prices. We have concerns that this scheme alone will provide the continuously traded market we are after, the large timescales between auctions will also lower confidence in the reference prices yielded.

Question 9: *Do you consider it appropriate to have buy-side rules in place and do you have any comments on the detail of such rules?*

It would seem sensible that there are buy-side rules in place to ensure that the proposed auctions have an imbalance, with parties unable to just sell, and then immediately buy their auction amounts back. However, we are not best placed to stipulate the detail of such arrangements.

Appendix

About the chemical industry

With an annual turnover of £50 billion, chemical businesses in the UK are a key contributor to the economy. Every working day, our sector adds £30 million to our country's balance of trade. The jobs of 600,000 workers in the UK depend on chemical businesses. Workers in chemical businesses earn on average 40% more than other parts of manufacturing.

The UK chemical industry is exposed to the risk of carbon leakage. We are highly energy intensive, accounting for 22% of total UK industrial consumption. We are also highly exposed to international competition in terms of both trade in our products and attracting investment. This is because our businesses compete in global markets and pricing of basic chemicals is very similar across Asia, North America and Europe. In addition, about 70% of sites are headquartered outside the UK ($^{2}/_{3}$rds of these outside the EU).

The UK chemical industry already has a excellent track record for reducing our own emissions, having improved our energy efficiency by 35%, and will continue to make improvements. But we are also enablers of climate change solutions in a wide range of applications across sectors of the economy including: households, transport, energy and agriculture. Examples of solutions include: building insulation, PVC and soda ash for double glazing, fertilisers and crop protection (to reduce land use), lightweight components for cars and planes, low temperature detergents, biofuels and materials for wind turbines. An independent study has confirmed that the global chemical sector currently delivers 2 tonnes of greenhouse gas savings for every tonne we emit in our production processes and that, with the right policy framework; this could rise to more than 4 tonnes by 2030. These results are summarised in CIA's low carbon brochure which also includes case studies to demonstrate that many of these solutions are already produced in the UK.