first:utility

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Dear Camilla,

Retail Market Review: Intervention to Enhance Liquidity in the GB Power Market

Please find attached First Utility's response to the Ofgem liquidity consultation regarding Mandatory Auctions.

Chapter One

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

We agree that the high level objectives of enabling affordable energy supplies and enhancing security of supply are important. We also agree that the GB Wholesale power market objectives referenced in figure 3 of the consultation document are important features in a liquid market. However, we believe that these features will develop naturally if the design of the market creates a need for participants, both upstream and downstream of the wholesale market, to trade in that market in order to manage their price and volume risks. The current market design does not create this need, which is the fundamental reason for the resulting low liquidity.

We believe the only way to ensure that these objectives are delivered is to design a wholesale market that creates a significantly higher need to trade, which will drive up liquidity and make the market price discovery mechanism more robust. Such a market will encourage new entry (rather than creating barriers to new entry as is the situation in the current market design). We believe new entrants who innovate and drive vigorous wholesale and retail market competition will drive improvements across the entire industry.

We do not believe that the Mandatory Auction (MA) proposed by Ofgem can deliver the increase in liquidity required to (i) attract new independent generation and supply or (ii) ensure that the CFD FITs being introduced under EMR are not gameable. We believe that the only one of the original four proposals from Ofgem that could deliver the step change increase in liquidity that is required to deliver (i) and (ii) is the Self Supply Restriction (SSR). All of the high level objectives and all of the wholesale market features Ofgem specify in figure 3 will naturally result from this alternative proposal and we strongly urge Ofgem to reconsider this liquidity intervention. Finally, we note that low liquidity is fundamentally linked to punitive dual priced cashout. We welcome a cashout SCR and encourage Ofgem to consider reform to a single priced cashout alongside an SSR, as we believe these two changes in parallel would stimulate far more competition in wholesale and retail markets.

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

We believe that the only objective Ofgem should be considering is to deliver an intervention that creates a deep and liquid forward and spot wholesale market with low barriers to entry. This will naturally result in market developments that will fulfill all the objectives stated by Ofgem.

Chapter Two

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

We agree that trading further along the forward curve remains thin and we believe that this low liquidity needs to be urgently addressed by a more effective intervention than the MA proposal.

Although we welcome more activity on day-ahead exchanges, this is of little benefit to new entrants and smaller players as the onerous credit terms in these markets create a financial barrier to participation. This barrier will only be overcome by driving up wholesale market liquidity so that financial intermediaries can participate and warehouse the price and credit risk on day-ahead exchanges and on the bilateral forward market, in order to offer structured products to independents. We believe the real increase in liquidity generated by the recent spot market announcements by some of the "Big Six" will be far lower than is being claimed. It is only the net volume (the sum of the sells minus the sum of the buys) injected into the auction by each participant that is meaningfully accessible to third parties in the auction, and we do not believe this number has meaningfully increased. Finally, we note that spot exchange liquidity does nothing to solve the liquidity problem further out along the curve. A prudent independent supply company would seek to purchase forward electricity contracts that match its view of forward contracted consumer demand (in order to lock in a forward gross margin). Such a supply company would generally only be exposed to the spot market for around 5% of its purchases. Any perceived increase in spot market liquidity is of little importance relative to the step change increases in forward market liquidity that are required to make it easier for such companies to hedge the other 95% of their price and volume risks.

We note that forward shaped product (the simplest product being forward seasonal peak load) hardly trades in the forward market, which makes it extremely difficult for independent suppliers to hedge their forward shape risks.

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

First Utility believes that a SSR is the only way to meaningfully drive up liquidity in order to satisfy both independent suppliers and independent generators and to create a robust reference price so that the CFD FiTs proposed under EMR are not highly gameable. We urge Ofgem to reconsider its view in relation to the SSR.

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

We agree that these objectives should be current priorities. However, we do not believe that a Mandatory Power Auction would be the best way to achieve this and would urge Ofgem to reconsider the SSR.

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Chapter Three

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

We do not believe that the MA will resolve the liquidity issue as intended. An MA will simply divert liquidity from one marketplace (the voluntary over-the-counter brokered forward market) into another (the MA) with the overall level of liquidity unchanged. The net liquidity in the MA is only 5% of a mandated party's generation output. We note that if the mandated sale is completely out of cycle with normal hedging patterns for all mandated parties, this will only drive an increase in churn from 300% to approximately 310%, which is far short of the metrics Ofgem state as being indicative of a liquid market. Instead, we believe that a SSR would be the only one of the four Ofgem proposals to meaningfully drive up liquidity. In a SSR, an integrated utility will be able to choose when to sell forward product, at what price, and to whom – the only restriction is that they would not be able to sell the product to themselves. We believe the SSR is a far simpler intervention to deliver and less expensive to monitor than an MA and all the complications involved in creating rules and monitoring compliance against a specific mandate in specific products, compliance with reserve rules and ensuring fair credit terms.

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

We disagree. In particular, we disagree with Ofgem's view that a Self Supply Restriction would not deliver Ofgem's objectives. One of Ofgem's key reasons for rejecting the SSR (outlined in paragraph 3.13 of your consultation document) is that you believe it is not clear that a SSR will result in the creation of availability in certain required products – for example shaped products in the forward market. However, we disagree with this view. If the generation arm of an integrated utility has to sell its output into the market, it has to find a buyer in that market. By implication, the supply arm of that same integrated utility would suddenly have a requirement to source its customer demand volumes in the market. We believe this sudden requirement on both sides to sell and source products of a particular type will result in vigorous trading in the market, which will drive not only robust price discovery, but also "product discovery". All the large supply arms of integrated utilities will suddenly have a need to source forward shaped product. In the liquid market that would emerge from a SSR, these products would rapidly be designed by participants and offered in the market to manage this need. So we believe that a SSR would not only create a robust base load and peak load forward price, but it would also create a robust forward shape price.

Ofgem's point in paragraph 3.14 of the consultation document concerns us. A 100% self-supply restriction would mean that no internal trades could be made between generation and supply arms. Therefore the supply arm would need to contract for 100% of its forward shape in the market, which it does not currently do. The generation arm would also have to sell 100% of its output into the forward market, which it does not currently do. This would create very meaningful liquidity for all market participants and would result in a price discovery mechanism based on vigorous buying and selling pressures in the wholesale market.

It is well documented that the "Big Six" claim to sell more than 100% of their generation output in the forward markets. However, this is voluntary trading, not mandatory trading. We believe that this trading falls into the following categories:

(i) Trading of bulk products on the forward market at the edges of the generation portfolios in order to "tidy up" the volumes that have not been needed to be transferred internally,

(ii) Sourcing of some supply volumes at the edge of the portfolio that have not been sourced internally, and
(iii) Proprietary trading in the trading arms of these vertically integrated businesses.

If the trading of the incumbents was already sufficient for liquidity we would not be arguing for key interventions to solve liquidity problems. If incumbents do trade several multiples of their generation portfolios, why is there no market price discovery mechanism for the trading of shaped forward products, and how does this explain the lack of liquidity in forward peak load products? We argue this is because there is more economic value in an integrated utility retaining this flexibility within their portfolio (as a cashout risk mitigant) than in selling this flexibility forward. A SSR would release this product into the market for all participants to bid for, driving up liquidity in all products, including forward shape.

Chapter Four

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

We do not agree.

Our view is that the MA will fall far short of delivering the increase in liquidity required to (i) support robust price signals for EMR CFDs, (ii) incentivise new wholesale and retail entry, (iii) support new investments in generation, particularly for independent CCGT developers, and (iv) encourage financial players back into the market.

- An auction with a reserve price is not a MA. As it is only the net volume that will be accessible to other participants, we believe that reserve prices will dramatically curtail the volume of power that is meaningfully accessible to other market participants.

- Any increase in liquidity due to the MA will be the net volume in the MA minus the reduction in liquidity created in other forward electricity market places. We believe that, given the other marketplaces are “voluntary”, there will be a significant curtailing of trading activity in these marketplaces so that there is no overall increase in liquidity brought about by the MA.

- If mandated parties are able to participate on the bid side, this effectively sets a reserve price for that power and gives parties the ability to net off buys and sells. Other market participants cannot meaningfully access liquidity that is “netted off”.

- Having a requirement for the “Big Six” to buy or sell a net volume in the auction means the generation and supply arms are implicitly mandated to share information with each other in order to comply. This provides them with extra market information relative to independents.

- An infrequent MA may be out of cycle with the natural hedging programmes of independents, meaning that the only way this liquidity will be accessible to them is if other intermediaries purchase this and warehouse the market risk until such time as the independents do wish to trade. However, we believe that low liquidity in an infrequent MA is unlikely to attract intermediaries back to this market. A weekly MA would be preferable, although it will have limited impact on liquidity in either form.

- Base and peak products are not sufficient. A liquid market should have a liquid forward shaped product price signal. We believe an MA should place an obligation on the mandated parties to release significant volumes of year-ahead EFA Block resolution products, with at least monthly granularity.

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?

We believe that there should be a prohibition on mandated parties participating on the buy side as we believe this undermines the very aims of Ofgem in creating a MA. An auction which allows buy side activity on mandated parties is not mandatory in our view, it is simply another marketplace.

If obligated parties sell 25% of generated output, they must buy either less than 20% or more than 30% so that a net volume of 5% is bought or sold. A net volume of 5% of the generated output of each obligated supplier being made available to the market is unlikely, in our view, to result in a significant change to the level of liquidity in the traded market. We note that the incumbents are structured so that they hold more supply than generation. This suggests that they will more often make a net purchase than a net sale in the auction. We find it difficult to see how this will drive availability of key products for independent suppliers.

Chapter Five

Question 10: Do you consider that there are benefits and risks to the approaches that we have not identified?

If the auction is cleared, there should be common credit terms for participants. These are likely to be more onerous from a cash flow point of view than smaller suppliers are likely to be able to bear. Ideally this problem would be overcome by the participation of financial intermediaries who might be willing to warehouse risk by mediating the auction on better credit terms for smaller suppliers. However, the fact that the auction will be mandating a low net buy or sell requirement makes it unlikely that financial institutions will be attracted to participate as the price discovery mechanism will be far from robust and the net volumes accessible will be small.

If the auction results in bilateral trades between matched counterparts, this will not assist smaller players as they are unlikely to have trading contracts in place (GTMAs and appropriate collateral agreements) with these counterparts due to the credit terms normally being too onerous and/or the risk premium required being too high for companies of this size.

We do not believe the MA will drive enough liquidity to enable independent generators to sell the products they need to sell to lock in generation margins. New CCGT developers need to be able to hedge forward cashflows from their new stations in order to secure debt financing, which often requires a long term hedge of at least five and often more than ten years. However, without a highly liquid market, the risks in offering a hedge to CCGT developers are too high as there is no way to offlay this risk in the market and prices further forward will be very exposed to risk of regulatory adjustments to EMR measures. Therefore we do not believe that the MA will allow independent generators to build new CCGTs without high levels of equity finance, which are unlikely to be forthcoming in volume for projects with such a high level of exposure to volatile illiquid market prices.

Question 11: Which approach do you consider is best placed to deliver our objectives at least in terms of cost and risk?

We do not believe either version of the MA is best placed to deliver Ofgem's objectives, as we do not think the MA can solve the liquidity problem.

If, despite our concerns, Ofgem progress the MA, we feel that approach one would be more suitable as (i) it would be the more cost effective solution, (ii) it is a more objective process if Ofgem tender for a platform rather than the obligated parties choosing and (iii) it reduces the amount of "liquidity fragmentation" – one platform means that liquidity will only be diverted from the brokered market into one extra platform by the MA. Several platforms in an illiquid market may mean that the price discovery mechanism in each platform is even less robust than with just one platform in an illiquid market.

Question 12: Do you consider that both approaches are able to meet our objectives?

We do not believe that either approach to the MA will meet the objectives laid out by Ofgem.

Please do not hesitate to contact Jonathan Smith (jonathan.smith@first-utility.com) or Chris Hill (chris.hill@first-utility.com) should you have any questions or require any further information.

Best regards,

Chris

Chris Hill

Regulation Manager

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