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

Dear Camilla,

I write in response to the Ofgem document Retail Market Review: Intervention to enhance liquidity in the GB power market

Overall view

SmartestEnergy would prefer a self-supply restriction (SSR) foremost, with mandatory market making (MMM) as second preference. Both we feel are the superior options to mandatory auction (MA) and sufficient independent of each other as an intervention in addressing liquidity. However, any market intervention would be a means of speeding up a process of improving liquidity which we believe is already in momentum.

We are of the view that current levels of liquidity are a function of the market structure which has come about due to a lack of regulatory foresight of the past; poor liquidity is a direct result of allowing large scale vertical integration to take place as it takes trade away from the market. There are several ways of tackling the negative impact of vertical integration on markets without forcibly separating companies. The solution Ofgem is proposing is to force the larger companies to sell 25% of their generated output on an MA. Unfortunately, using an MA to solve the problem of liquidity means smaller suppliers will have to enter into additional markets even though they are not the cause of the problem (unlike SSR which still achieves the same objective without these issues).

The proposed MA will be ineffective because it does not feature continuous trading. Continuous trading is required to cover price risk on deals, one of the main supposed barriers to entry/further competition. Even worse, it risks taking volume out of continuous trading, concentrating volume in monthly peaks, prompting reduced trade before and after the auction is about to happen, and hence reducing liquidity. A proliferation of auctions runs the risk of merely spreading liquidity more thinly. Also, having a monthly auction as opposed to an open market will create artificial demand and consequently increase prices which are then passed on to consumers on top of the set up costs they will bear. Both results are the very opposite of Ofgem's intentions.

We are also of the view that such a regulatory intervention as envisaged by Ofgem may be excessive at this stage. This is because the recent developments in terms of liquidity in the near-term markets should with time cascade backwards through the curve. In addition there is the potential impact of upcoming changes in the market; trading around FiT CfDs will bring additional robustness and we anticipate that once certainty around EMR improves, so too will liquidity. On top of this the creation of the GB hub should further improve liquidity. In other words, we should see improving liquidity due to the harmonisation of European day-ahead markets, as has been experienced in the NordPool.

The industry's own solution, the Nasdaq futures exchange, has only recently established itself so it is taking time for it to be fully utilised. It is anticipated that this exchange will encourage Europeans and financial players to get involved as it is financially settled, contains small volumes of 5MW and also is calendar traded like the rest of Europe.

Ofgem should also be mindful of the fact that not all changes being mooted are to the benefit of liquidity, such as the proposal to effectively remove dual accounts (P282) which could lower liquidity. It would appear inconsistent to us to consider proposals which would reduce liquidity at a time when as much liquidity as possible should be encouraged.

Ofgem's specific questions

We now answer Ofgem's specific questions below in the order in which they appear in the consultation document.

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

> To an extent the large vertically integrated companies are victims of their own strategies; they have internalised their risks but thereby reduced the liquidity in the market for products to fine-tune their position which they themselves would like to see. We believe that the Big 6 are beginning to see this now and this is why some of them have decided to externalise their trading requirements. Given that this is a relatively recent development, it would be wrong to assume that liquidity will not improve further along the curve without any intervention.
>
> The document suggests that it is important that suppliers are able to "enter the market and grow" as this is good for competition and keeping prices low. We would like to point out that companies which have failed in the past have not been in a strong financial position. The biggest barrier for new entrants is credit

and creating an additional auction will make things worse, not better. Also, another big barrier is being able to cover price risk on deals which requires continuous trading (which does not appear to be a feature of the MA as proposed).

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

Ofgem should have an overarching objective of ensuring that the market structure is appropriate so that the lower level objectives stated come about as a natural consequence.

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

We agree that most progress has been created in the effectiveness of the near term market.

The document states that "key policy developments, such as the progress towards an integrated day-ahead market and the Government's Electricity Market Reform programme provide important context to our proposals. These developments support the conclusion that the development of an MA focused on objectives one and two is appropriate."

It is true that EMR and European developments provide an important context to the proposals. Ofgem's conclusions, however, are completely wrong; these initiatives will improve liquidity and thus obviate the need for an intervention such as the MA.

It has been identified that in order for the EMR proposals to be successful a robust reference price is required. This does not mean that liquidity can be created ahead of the FiT auctions/contract awards; the liquidity itself will manifest itself as parties trade to hedge against their FiT CfD obligation.

Similarly, churn and tighter spreads are evidence of a liquid market but their absence is due to the lack of financial players in the market. Ofgem should be considering ways which encourage more financial players into the market. One such way could be to move to single cash-out but this needs to be weighed up against some downsides such as greater volatility in the cash out prices and a greater tendency for intermittent players to go long due to the decreased incentive to balance.

We note that liquidity has worsened since the announcement of the Carbon Price Floor. We anticipate that liquidity will improve once there is more certainty around EMR. It is therefore be unnecessary to intervene now with an MA.

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We note significant decreases in the activity of several players most notably Cargill, Koch and Citigroup, due possibly to the comparative likelihood of regulatory uncertainty in the UK. Market participants exiting the market could be just part of the general credit tightening (post Lehman's and eurozone crisis), but it would appear that these companies are choosing to leave UK power rather than other markets because of the regulatory risk and lack of liquidity.

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

Smaller clip sizes (preferably minimum of 5MW rather than the current 10MW) offered through OTC brokers would be helpful. This is because the inability to purchase products in small volumes presents a barrier to entry and growth for smaller market participants.

It would be unreasonable to expect half hourly shape to be traded more than two days out. If a standard domestic load profile is to be offered we feel that business equivalents should also be available such as the standard business shapes which traded in the days of the Pool. We would like to see all the EFA blocks available for coming seasons and months and also a weekday block 5 for coming seasons and months

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

We feel that objective 1 is of a greater priority than objective 2. In the longer term we think that even objective 1 will be met in the natural course of events. However, objective 2 is already well on the way to being fulfilled as we are experiencing greater trades on the near term market and the nature of trading around FiT CfDs will bring additional robustness.

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

No. We believe that the mandatory auction would be more appropriate if objective 2 were not being met. However, we believe that it is very close to being met and Ofgem themselves consider objective 1 to be the greater failure. We are also of the view that a mandatory market making (MMM) obligation addresses objective 1 better.

The document states: "We still consider that the MMM arrangements we proposed could help to deliver a near-term market which meets small suppliers' shaping needs. However, as discussed in chapter two, we recognise that market developments since July 2011 have lessened the rationale for intervention targeted at near-term improvements."

However, there is no justification for rejecting a wider MMM which would provide continuous trading and addresses the more important objective 1. The document focuses on how the previously defined MMM does not meet the needs of objective 2. It would have been better to analyse how a wider MMM does.

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

Apart from the SSR and MMM mechanisms, SmartestEnergy would agree that the other mechanisms are not appropriate. In addition, we believe the reasons for rejecting SSR and MMM are not strong enough.

Ofgem appear to view the implementation of a SSR as being defined in terms of the percentage traded versus physical requirements. However, we envisage an SSR to prevent large companies from trading between their generation and retails arms completely, forcing all generation through market and not merely increasing their trading volumes. In light of this correction, the arguments against the SSR should be re-evaluated.

As stated previously, we believe that MMM addresses objective 1 better than an MA.

Ofgem need to be careful not to open themselves up to the accusation that they are not willing to pursue MMM or SSR on the grounds that it would involve greater involvement of Ofgem themselves. If the better options require greater Ofgem involvement then so be it.

It could also be perceived that Ofgem have landed on the MA as the most appropriate intervention because it is the least objected to by the Big 6 and have then sought to justify the decision. Again, this should not be the way in which policy is determined.

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

We are not in favour of monthly auctions as these would actually push prices up due to creating artificial demand. The MA could concentrate volume in monthly peaks, prompt reduced trade before and after the auction is about to happen, and hence reduce liquidity. There is also a danger that monthly auctions will take liquidity away from the other trading platforms, spreading liquidity more thinly. To reduce the risk to small counterparties it is necessary for trading to be continuous. Ideally any auctions would need to be daily but if they became daily the OTC market would suffer; from a traders' perspective the MMM is a much better solution.

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If Ofgem does indeed implement monthly auctions then it would be better if they were focused on shaped products. Whilst we agree that it is not necessary, or indeed, fair to place an obligation on the Big 6 to offer bespoke shaped products, we do believe that there should be more block shaped products on offer further out. However, a peak product which goes out to Season +4 is welcome.

It is unclear to us how the 25% obligation will be spread over time. For instance, if there are monthly auctions the season products will presumably be available on several occasions. It needs to be made clear whether the obligation to sell is to have sold the month before it can no longer be available or whether the obligation is to sell some season products each month.

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 are not convinced of the absolute need for this. Most of the Big 6 are actually net short, so, under the rules as proposed they will each have to sell 25% and buy back 30%. Indeed, the Big 6 will be in competition with smaller suppliers buying back that 5% and this could lead to artificially inflated prices.

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

A possible advantage of the second approach is that the liquidity may not be as concentrated on one platform and at exactly the same time.

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

Of the two approaches we prefer approach two whereby Ofgem determines and oversees, with stakeholders, the features any service provider would have – but the obligated parties themselves identify the platform or platforms. This is preferable to Ofgem running a tender for a platform services provider and determining and overseeing the key features of the arrangement.

We believe that the obligated parties will be incentivised to use, as far as is possible, existing platforms, although we believe this because of the obligation to trade a proportion of their requirements rather than merely an obligation to make it available. Clearly, if the obligation were merely to make it available then there may be an incentive for them to make access to the market as difficult as possible.

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

Yes, both options for identifying a service provider/providers would meet the objectives. However, we would not like our agreement to this question to be used as acceptance that the proposal has our support.

Should you wish to discuss any aspect of this matter, please do not hesitate to contact me.

Yours sincerely,

Colin Prestwich
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