Consumer Focus
Campaigning for a fair deal

15 February 2013

Phil Slarks
Ofgem
9 Millbank
London
SW1P 3GE

Dear Phil,

Response to 'Wholesale power market liquidity: consultation on a "Secure and Promote" licence condition'

Thank you for providing us with the opportunity to respond to this consultation. Our submission is entirely non-confidential and may be published on your website.

We have been here for a while:

> *"British Energy, Edison Mission Energy and Corus raised concerns about the development of liquidity in the wholesale market, particularly in respect of derivatives trading, the availability of medium and long-term bilateral contracts and the shallowness of shorter term markets.*
>
> *"Some respondents ... raised concerns about the impact of removing the [self-supply] restriction on wholesale market liquidity. In particular, some respondents felt that liquidity was yet to fully develop or that there may be a future decline in liquidity.*
>
> *"This "restriction on self-supply" was introduced into the licences of some former PESs at a time when competition in supply was in its infancy. It was designed to facilitate supply competition by promoting liquidity in the wholesale market.*
>
> *"Ofgem considers there is little evidence to suggest that vertical integration is adversely affecting liquidity and transparency."*
>
> - Ofgem, 'Restriction on self-supply - Final proposals'[1], October 2003.

[1] http://tinyurl.com/ae4pmyf

Consumer Focus
Victoria House
Southampton Row
London WC1B 4AD

t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk
www.consumerfocus.org.uk

"Key issues in GB energy markets: Liquidity. Declining in power and gas. 'Post Enron blues' or worrying trend?"

- Ofgem, 'City briefing: Key regulatory issues for 2005'[2], February 2005.

"Small suppliers and potential new entrants have highlighted the lack of liquidity in the wholesale electricity markets and raised concerns about the functioning of the wholesale market itself.

"We will begin, urgently, a programme of work to identify the underlying causes of low wholesale market liquidity, and explore with the Big 6 suppliers how best to achieve a significant increase in liquidity."

- Ofgem, 'Energy Supply Probe: summary of initial findings & remedies'[3], October 2008.

"The main reason for the lack of independent activity is likely to be the barriers to entry in both wholesale and retail markets. The primary barrier is low wholesale market liquidity. The lack of liquidity arises from the vertically integrated companies 'self-supplying' their electricity"

- HM Treasury & DECC, 'Energy Market Assessment'[4], March 2010.

"We recognise that the improvements to the market that we want to see take time. However, we cannot wait indefinitely"

- Ofgem, current consultation, December 2012.

Poor liquidity in the power market, particularly in forward products, has been a problem since around 2003/04, was first acknowledged as such by Ofgem in 2005 and is something that it has been 'urgently' working to tackle since 2008.

We recognise that Ofgem's instinct is to try and go with the grain of the market where it can, and to intervene as a last resort. This can be an appropriate approach when the market has not had an opportunity to self-correct and where the alternatives may credibly be worse. However the strategy of giving the market time and space to self-correct has already been tried with liquidity over many, many years - and forward liquidity remains dismal. 'Wait and see' hasn't worked. You now need to act.

The Government intends to insert backstop powers to tackle the liquidity problem in the Energy Bill that is currently progressing through Parliament. We will be calling on it to act on those powers immediately that they come into effect if Ofgem has not implemented an enduring solution by that point.

[2] http://tinyurl.com/ajpvybq
[3] http://tinyurl.com/aqhd2sr
[4] http://tinyurl.com/a3g2sww

Consumer Focus
Victoria House
Southampton Row
London WC1B 4AD

t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk
www.consumerfocus.org.uk

The perfect can be the enemy of the good

Independent market participants, whether generators or small suppliers, will know what products or platform for trading will help them far better than we possibly can. Indeed, there is considerable plurality within both sub-sectors and it is unlikely that a single solution will suit all. We therefore do not wish to comment on the detailed components within the proposed models; these are questions for small players and prospective new entrants. We would simply caution that a lack of consensus on finer design points should not be used as a justification to delay further action – there has never been a single industry voice on the best way forward on liquidity and holding off on acting in the hope that you can achieve one may simply be a recipe for delaying progress indefinitely.

We do however wish to comment on the high-level options on the table.

Preferred option

There are significant differences between the two options on the table. Only Option B attempts to tackle problems with forward market liquidity, which, as you acknowledge, is the area where least progress has been made.

We recognise that Option A would help to 'lock-in' progress made on Objectives 1 and 3, and that it may provide some incremental progress on Objective 1 by requiring the Big 6 suppliers to offer fair and reasonable terms. While we do not underestimate the difficulty in prescribing or enforcing what is 'fair and reasonable' this should nonetheless provide reasonable stimulus to the major suppliers to keep working towards providing products that support hedging.

Despite this modest improvement, we cannot support Option A. This is because it is effectively a 'do nothing' approach towards the forward market (Objective 2), continuing to give the market time to try and find its own solution there. 'Wait and see' has failed to provide a solution to forward market illiquidity despite being given (far too) much time. We therefore lack any real confidence that Option A has a credible chance of working.

We can, and do, support Option B based on the introduction of a market maker obligation. The outline of this set out in Figure 12 appears broadly proportionate, targeted and logical. The most problematic provisions appear to us to be those relating to bid/offer spread; while the other provisions are relatively clear-cut, the ones in this area are open to interpretation. For example, what is a 'significant volume' – and in whose eyes? How much wider does a supplier's spread have to be than the other suppliers, or other market makers, before it falls foul of the 'is not significantly larger/wider' provisions? And so on. These problems are not substantial enough to justify not including rules in these areas, however you may need to provide relatively detailed guidance on how they will be applied in order to avoid the risk of industry confusion or enforcement difficulty further down the line.

While we have some sympathies for the 'obligation to trade' alternative we regard it as a distant second choice option, for the simple reason that it appears to us to be considerably less developed than the market maker approach. There is an urgent need to make progress in tackling the illiquidity in forward markets; starting to develop wholly new models is likely to delay this still further.

Consumer Focus
Victoria House
Southampton Row
London WC1B 4AD

t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk
www.consumerfocus.org.uk

Materiality

If Ofgem is to legitimately consider the 'do nothing' approach on forward markets envisaged by Option A, we think that it needs to articulate the consequences of this.

The consultation does not attempt to put a value on the consumer detriment resulting from illiquid markets, although it does explore some of the consequences in a qualitative way.

While difficult, we think a quantitative assessment could be possible. For example, you could infer the transactional costs associated with current bid/offer spreads versus those that you would expect in a healthy market; look at how hedging risk affects the cost of capital of new entrants; and so on.

Liquid forward markets are an excellent way of signalling the long-term value that consumers place on security of supply; given Ofgem's widely publicised security of supply concerns, this should be pertinent to its decision on how quickly it needs to act. Either you think security of supply is a problem or you don't. Which is it?

In the event that you decide not to act on forward market liquidity we would expect to see this accompanied by a very strong case that the financial consequences of further delay are not significant. We doubt such a case exists.

Learning lessons – this would not be an appropriate area for a sunset clause

Ten years ago Ofgem scrapped the previous 'self-supply' licence conditions preventing the large vertically integrated energy companies from selling the output from their generation arms directly to their supply arms, arguing that this protection was not necessary in spite of evidence that wholesale market liquidity was deteriorating. In the subsequent period, self-regulation has not resulted in a liquid traded market despite considerable political and regulatory pressure on the market to find a voluntary solution.

Given the protracted nature of the problem, and the failure of self-regulation to tackle it, we would caution that any 'secure and promote' licence condition inserted into large players licences should not be time-limited (i.e. be subject to a 'sunset clause'). We cannot and should not go through this process again.

I hope this submission is helpful. If you would like to discuss any point raised in further detail, please do not hesitate to get in contact.

Yours sincerely,

Richard Hall
Head of Energy Regulation

Consumer Focus
Victoria House
Southampton Row
London WC1B 4AD

t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk
www.consumerfocus.org.uk