Ofgem blends potent liquidity cocktail

Ofgem's consultation on a new proposed approach to fostering liquidity via a "secure and promote" licence condition closed last week. We have long argued that the time for intervention is overdue, and in this week's *Energy perspective* we take a closer look at the latest proposals, and conclude that they represent a coherent package and should form the basis of early implementation.

Mixology

The latest consultation was issued on 5 December. It is seeking to drive to a conclusion a work-stream that has been running since 2009 and has evolved extensively since then.

Progress against liquidity objectives

	Objective	Progress
1	Availability of products which support hedging	
2	Robust reference prices generated along the curve	
3	Effective near-term market	

Source: Ofgem

Some while back Ofgem set itself three objectives (*see chart right*), and the latest consultation again reviews progress. It believes there has been some industry-led progress on two of the objectives. On the first objective to improve the availability of products which support hedging, large suppliers have made trading commitments and anecdotal evidence suggests terms available to some smaller players have improved. The growth of trading on day-ahead auction platforms has also supported development of an effective near-term market, and therefore progress towards objective 3.

But Ofgem is rightly concerned there are dangers that, unless these moves are backed up with intervention, progress could halt or even be lost when regulatory focus moves elsewhere. Furthermore there has been little positive to report on the second objective of developing robust reference prices along the curve, and there are indications that the focus on day-ahead trading is diverting the limited liquidity further out.

Scarlett letter

The regulator's approach in the December consultation has developed in response to some signs of progress in the market.

Last spring it consulted on proposals to obligate the Big Six to auction 25% of their generation through a Mandatory Auction (MA), but this drew widespread opposition (*ES335, p2, 02/07/12*). The main concerns are that an MA could cause distortions, be very expensive to operate and is ultimately unlikely to help the smaller and independent participants the intervention was designed to benefit. This option is now firmly on the back burner, although the regulator has not dismissed it entirely. But Ofgem now makes clear it is continuing to develop the mechanism to ensure it is a "robust option" for intervention if needed, looking at a unified single auction process in a "hub", refining the buy-side rules and amending the list of products.

Instead the regulator is now considering a new approach, which builds on recent market developments. It has proposed a "secure and promote" (S&P) licence condition that would secure market developments to date and push for further improvements. The condition would apply to the Big Six only, with a review after three to five years of whether it is still appropriate. A key aim in addition to increasing liquidity would be to try and ensure that smaller market participants can access the electricity they need to be able to compete effectively, the terms are transparent and they are treated fairly.

Tetanus shot

The first element of the "secure" part is to codify the requirements that the Big Six must stick to when negotiating trade agreements with independent suppliers, on the grounds that existing high-level voluntary commitments may not be enough or prove enduring. This is an area where some independents have noted improvements, but there remain significant concerns that behaviour changes have been tactical and by no means universal.

Ofgem set out some illustrative requirements, including minimum clip size, product range, a requirement to base quotes for products on a recognised market index, and prompt responses to trading requests. The Big Six would be required to offer reasonable credit and collateral arrangements based on a bespoke calculation in relation to each counterparty, a critical issue for many independent suppliers and one that has been neglected in Ofgem's work to date.

Ofgem proposes targeting the requirements on trades with independent suppliers as the parties that face particular problems, to minimise the cost of the obligation and enable the licensees to take a targeted approach. Requirements to ensure fair and reasonable trading terms are necessary and sensible and should help independent suppliers to get access to, and fairer deals from, the market. There is an issue over how detailed these requirements should be; it has asked, for example, whether it is appropriate to impose a particular approach on the pricing of shaped products. But this debate over detail should not detract from the merits of Ofgem's proposed approach.

Secure and Protect licence options

	Objective	Option A	Option B
1	Availability of products that support hedging	"The licensee must offer fair and reasonable terms when negotiating trading agreements"	
2	Robust reference prices generated along the curve	*No specific intervention: can be met by liquidity evolving along the curve based on a robust near-term market*	*Range of intervention options to promote objective two (eg a marke maker obligation)*
3	Effective near-term market	"The licensee must buy and sell at least 30% of its generation on a day-ahead auction platform"	

Source: Ofgem

Fluffy duck

Ofgem's third liquidity objective is the development of an effective near-term market, where some good progress has been made as seen by the growth in volumes traded on day-ahead auction platforms. The increase has been driven to a large extent by the "gross-bidding" agreements, now signed up to by all the Big Six, to trade specified volumes on both sides of the auction. Ofgem thinks there still could be a rationale for locking this progress in through a licence requirement, providing the market with some confidence that this liquidity is going to last.

This aspect of the licence condition would not involve new actions by the Big Six and so would be cheap to implement. It would require that they buy and sell at least 30% of their annual generation through a day-ahead auction platform, and provide Ofgem with information on their generation volume and on volumes bought and sold. Reports to the regulator will provide early warning of any slippage.

One impact might be to focus liquidity on the day-ahead auctions and potentially drain it elsewhere. But overall this part of the proposals seems to be the least potent.

Magic sparkle

While progress has been made on the first and third objectives, Ofgem sees little progress on the second – developing robust reference prices along the curve. It has presented two possible options here: allow forward trading to develop naturally, needing no specific intervention, based on developing outwards from a robust near-term market (Option A); or making further intervention, for example, in the form of a market maker obligation (Option B).

The argument for Option A is that an improved near-term market will form the basis for improvements in liquidity along the curve with liquidity developing naturally, so avoiding unintended consequences from regulation. But Ofgem concludes there has been little progress to date outside of the day-ahead market; the likelihood of financial products filling the gap, which had at one stage looked promising, appears to be making slow and sporadic progress. It is also not clear that there is a natural progression from liquidity in the short term to liquidity further along the curve. There are different drivers; the former allows parties to refine positions based on immediate issues such weather and outages; the latter is related to company hedging strategies for locking in wholesale product for retail offers.

One driver for change is the Electricity Market Reform stream, which Ofgem notes could affect market liquidity. The Contracts for Difference will require a liquid market on which to base the reference price, which may encourage generators to trade in markets from which the reference price is drawn. The current proposal is that baseload contracts will be referenced against seasonal indices. But there is also a wild card in Ofgem's electricity balancing Significant Code Review which, although still at the early stages, could affect liquidity through the incentives on market participants to balance.

These uncertainties, together with the slow pace of progress, make a strong case that waiting for market developments to deliver liquidity further out risks continuing without an efficient and effective market. Although DECC will have fall back powers in the Energy Bill to boost liquidity, action is needed now.

Trog hammer

The regulator's lead option for intervention here is a market maker obligation whereby the Big Six would be required to make a market in specific key products on any standard, commonly used GB trading platform for up to 10MW and the licensee must post prices for more than 50% of the market opening time in any given calendar month. The idea is to ensure prices are available for longer-dated products, helping provide robust and transparent reference prices and providing confidence that participants can trade at these market prices on a continuous basis.

One of the more difficult design areas is Ofgem's proposal to place requirements on the bid-offer spreads offered. The spreads must be such that they would: allow significant volumes to be traded over the course of a year; not be significantly larger than spreads posted in existing market making arrangements in GB and other European energy markets; and not be significantly wider than others of the Big Six. The principle is right even if the detail will require a bit of fine-tuning.

The mechanism will clearly impose some costs on the market maker itself, albeit the regulator expects that in most cases the market maker will profit from trading. And there are also other issues to resolve such as who closes the platform to trade and whether there is any potential conflict with new European rules on markets in financial instruments. But the approach should guarantee greater price visibility and kick-start the longer-term market.

A dash of bitters

Ofgem also outlined one further option, the idea of an obligation to trade, which would simply be an obligation to trade (buy or sell) a certain volume in specified long-dated products each year, with a minimum percentage (for instance 5%) to be met each month. This solution would, according to Ofgem, avoid the difficult design issues of the market maker and would ensure there was actual trading, and not just prices being quoted.

However, there are concerns that this approach could distort the market, particularly if the large volumes likely to be required to make it effective were imposed. Ofgem's is worried too that a requirement to trade a particular volume could create distressed buyers or sellers. If this caused the obligation to be met by trading at an artificially low or high price, it could prevent the mechanism achieving its second objective of a robust reference price. We agree with this assessment, and strongly prefer the market maker approach.

Gauntlet

At two recent workshops to consider the consultation proposals (although not in the consultation itself), the "self-supply restriction" emerged once more. This option could ban the transfer of power between the generation and supply arms of vertically-integrated companies, or require them to trade a volume equal to a percentage (for instance, not less than 50%) of generation on the market. Interestingly two of the Big Six are now indicating public support for this route.

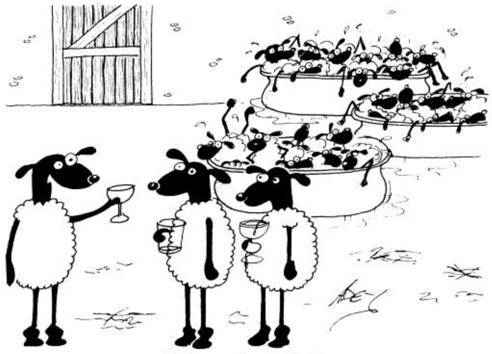
Ofgem maintained at the events the line from previous consultations that this route is unenforceable. To this we would argue it may not significantly improve liquidity in long-dated products or facilitate market access for smaller players. The regulator also identified challenging design questions, for example on the approach to auction volumes. Nevertheless it said it will consider any representations on this option too.

Resolution martini

The regulator now has a "strong preference" for intervention to improve liquidity and "cannot wait indefinitely". We agree, and have been of the view for nearly a year that some form of facilitated trading arrangements cast against defined outcomes is the right way forward. The S&P package has real merit and provides an appropriate framework in which the Big Six can work towards delivering these. The focus needs to be firmly on objectives 1 and 2, with a market maker clearly mandated.

Another positive aspect of the package is the compliance framework. The Big Six would be required to report annually against application of the objectives, with the regulator issuing an annual assessment. This would be an opportunity for Ofgem to share best practice and ensure the spirit of the requirements is being followed.

Ofgem aims to make a decision on intervention ahead of the summer and, if it decides to go ahead, licence changes are expected before the end of this year. Assuming it proceeds in this way, there should be no need for DECC to utilise its proposed fall-back powers.



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