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The Renewable Energy Company (Ecotricity) Consultation Response to The Retail Market Review: Liquidity Proposals

Dear Phil Slarks,

Introduction

Ecotricity is an independent renewable energy supplier and generator with around 70,000 domestic and non-domestic customers.

We welcome Ofgem's plans to improve liquidity in the wholesale energy market. This is an issue that we have long been concerned about and have been actively engaged with Ofgem for the past 3 years.

On the 12th of October 2011 Mark Hollands presented Ecotricity's proposal to increase liquidity via a "market exchange mechanism" at Cornwall Energy's Small Supplier Profile Raising Event, which was attended by a number of industry participants as well as Ofgem and DECC. We are very pleased to see that many of the elements of this mechanism are included in Ofgem's proposed "Obligation to Trade" alternative and we strongly advocate this as a way forward.

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Answers and Questions

Question 1: *Do you agree with our assessment of market developments?*

We agree with Ofgem's assessments that churn, and therefore liquidity continued to decline over 2012.

With regard to Ofgem's first objective; availability of products that support hedging; we agree that the proportion of baseload products available remains limited. We acknowledge that there have been commitments made by the Big Six to independents; however we do not believe that this would have happened without the regulatory threat from Ofgem. It should not be assumed, therefore, that this level of commitment would continue indefinitely without intervention. We agree that the level of financial trading has been limited; however we do not see this as a problem in itself. Liquid markets attract financial traders, but financial trading does not create liquidity. It is therefore an indicator of liquidity, not a determinant and should not be a policy goal in itself.

With regard to Ofgem's second objective; robust reference prices along the curve; we agree that the narrowing of spreads which occurred in 2011 has reversed. It is important to note, however, that spreads are affected by external factors such as global commodity prices and demand, and therefore spread sizes are not a reliable indicator of liquidity. Spreads have fluctuated in recent years, but churn (and therefore liquidity) has remained low. The primary focus of Ofgem's assessment of liquidity should be churn.

With regard to Objective 3; an effective near term market; we accept that a high volume is traded on near term exchanges. However, we note that both APX and N2EX have been flat for about 6 months and we would caution that high volumes do not necessarily indicate high liquidity if that volume is traded only a few times.

In the past two years there have been four major step increases in volume on N2EX; however these increases in volume have not resulted in increased churn. The May 2010 volume was initially followed by a small increase in churn, but it remained largely stable overall. The October 2011 increase had no substantial effect on churn; the January 2012 volume increase was followed by a gradual decline in churn; as was the June 2012 increase. Again, we would like to stress the importance of churn as the primary indicator of liquidity.

It is also worth noting that during this period, the volume traded on APX did not increase. It should not therefore be assumed that volume traded on one exchange will affect volume on another.

Question 2: *Do you agree with our description of the policy and regulatory context affecting liquidity?*

We are unsure whether uncertainty in the regulatory context; such as Electricity Market Reform, the European Target Model and EU Legislation; have further dampened liquidity. We do not, however, agree with Ofgem's conclusion that the uncertain wider regulatory context is a reason to delay interventions to improve liquidity.

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Question 3: *Are there other factors that we have not identified that may be posing a barrier to improvements in liquidity?*

We believe that the protracted approach to date that Ofgem has taken towards intervention may in itself been a barrier to liquidity improvements.

Question 4: *Do you agree that the Secure and Promote model presented in this document could help to meet our objectives?*

We do not believe that the "Secure and Promote" model goes far enough to meet Ofgem's aims. We support the proposal to mandate reasonable terms particularly in relation to credit and collateral requirements, but a straight forward requirement to make products available on good terms would not in itself be sufficient.

Question 5: *Does our proposed structure for Secure and Promote seem appropriate?*

No it does not. It is not clear at this stage whether Ofgem would specify a particular platform on which long term products would be made available, within the proposed "Trading Requirements Document"; but if obligated parties are able to fulfil their obligations through bilateral trades then this would have a far lower impact on liquidity than an exchange based solution. Furthermore, bilateral trades are very difficult to audit and the quarterly and annual reporting requirements proposed by Ofgem may be difficult to verify.

Question 6: *Do you think the proposed Secure and Promote model would be a more effective intervention than the Mandatory Auction?*

We believe that both proposals have advantages and disadvantages and that an approach which combines the advantages of both models should be followed.

For example, a key flaw of the MA is that it would be monthly rather than continuous. This would likely result in spikes in activity and distort market prices rather than simply increase liquidity overall. The "Secure and Promote" licence condition would not have such spikes but since it may not increase exchange based trading, it would not have the other advantages of transparency and availability for all that an exchange has.

The proposed Obligation to Trade in Chapter 4 of the consultation document is a good example of how the advantages of the MA and "Secure and Promote" proposals could be combined. Please see our response to Question 11 for more detail on this.

Question 7: *Do you have any views on the requirements we have set out for trading commitments – in particular those points listed under "outstanding design challenges" on page 25?*

With regard to scope, the obligation should apply to all companies with a generation licence, rather than just the vertically integrated Big Six. If, as we strongly advocate, an exchange mechanism is taken forward then the requirement should be to sell to all parties, not just independents.

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Whichever model is taken forward there must be measures to ensure fair access to credit. There should be flexibility in terms of the form of collateral allowed (cash, letter of credit or parent company guarantee) and the amount required should not vary depending on the size of the company. This would be far easier to ensure through exchange trading than under bilateral arrangements.

With respect to products it is important that small clip sizes be available (at around 0.1 MW granularity). As stated in our response to the February 2012 consultation, there needs to be more emphasis on shape further along the curve, with the level of shaping reducing over time. For season 1 it should be possible to buy in two hour blocks; for season 2 four blocks; for 12- 24 months ahead peak/off peak should be available and; for 24-36 months ahead base load is sufficient.

Question 8: *Do you have any views on our proposed approach to securing existing developments in relation to day-ahead auctions – in particular those points listed under "outstanding design challenges" on page 28?*

We do not believe Ofgem needs to focus on regulating liquidity in the near term market. This will evolve if liquidity further out is ensured because parties that have traded further out will need to balance their position in the near term market.

We believe that Ofgem's continued focus on day-ahead is because of the need to account for intermittency as more wind power comes online. It is important to note that small scale wind does not lend itself well to day ahead trading, since forecasting uncertainty means it can only be sensibly traded within day. Therefore, day ahead auctions are not necessarily the most appropriate way to deal with intermittent generation, particularly in relation to reference prices. Consideration should be given to using within day trading.

Question 9: *Will trading along the curve naturally develop from the near-term market?*

No,this is a question that has been raised several times, despite there being no evidence to support the hypothesis that short term liquidity naturally develops along the curve. Near term liquidity has been relatively high for the last two years but this has not spread out across the curve. As stated above, the market works the other way around with long term liquidity influencing the short term market.

Question 10: *Should Ofgem intervene to ensure that robust reference prices along the curve develop?*

Yes, it is essential that Ofgem intervene to ensure robust reference prices along the curve. Not only is this important for improving trading conditions, it is also necessary for Government policies such as Electricity Market Reform.

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Question 11: *Is market-making the most appropriate intervention option to promote robust reference prices along the curve? What is your view on the trading obligation option that is outlined on page 34?*

We do not believe that a market maker would be an appropriate solution to low liquidity and poor reference prices. Requiring the market maker(s) to set the prices along the curve will not result in a robust reference prices as there is a high potential for price setting and little guarantee that prices chosen will be attractive to independents. It is difficult to see how the requirement to keep bid-offer spreads narrow could work in practice and how parties would be penalised if spreads remain wide.

We have raised concerns that a market maker would effectively set prices. In discussions, Ofgem argued that the need to keep spreads narrow will ensure that the market maker remains responsive to other market participants. We remain concerned that the market maker would have a disproportionate amount of power; this is a particular danger if there is just one market maker.

It is not clear who the market maker would be. In the consultation document it appears to be the vertically integrated Big Six; however, statements made at Ofgem's roundtables suggest that this may not be the case. Ofgem must consider the potential for market manipulation by a market maker. We strongly favour the market making obligation being on all multiple parties including the Big Six as this will reduce the concentration of power and potential for manipulation. We note, however, that under this option there is a risk that obligated parties would ensure narrow spreads by purchasing at the high prices that they themselves set. This would not ensure products are available on fair terms to smaller parties, who are the intended beneficiaries.

We strongly support Ofgem's alternative option laid out on page 34: an Obligation to Trade. However, rather than allow trading on any platform, the requirement should be for all parties to trade on a specified platform that is put out to tender. A single platform would allow liquidity to be measured and would give rise to more robust reference prices. It also reduces the collateral requirements for parties trading on that platform.

We support the other elements of the proposal, such as splitting the requirement across a range of forward products in both baseload and peak variants; however, this should be in an ascending profile from near to longer-term rather than a descending profile as suggested. The reason for this is that, as stated above near term liquidity is already relatively strong and will in any event improve if liquidity far out improves; the reverse is not true.

We agree that a minimum amount would need to be traded each month; this would prevent peaks as all parties rush to fulfil their obligation at the end of the year.

We also support an obligation to report the volumes traded; however we believe that this should go further than currently proposed. We would advocate a reporting obligation on all trades. This requirement should include price and volume and be reported to a third party such as Elexon, which would be the only body to see the raw data. Elexon could then produce a report on overall volumes and prices traded and send this to Ofgem. This should apply not only to any new platform introduced to facilitate this obligation to trade, but also

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to all trades on APX, N2EX, any OTC platforms and bi-lateral trades. This would greatly improve knowledge of actual liquidity and increase transparency; something that is vital for the EMR. We appreciate that there are already private companies such as Heron and Argus that produce reports. However, they do not cover the whole market as bilateral trades are excluded. There is not sufficient oversight to regulate how these private companies operate and there have been examples of manipulation in their reports.

This approach would have a substantial advantage over the market maker. As acknowledged by Ofgem, it would avoid the need to regulate bid offer spreads because the need to buy and sell obligated volume would ensure that licensees would price at a competitive level. We agree that allowing for continuous trading would also give it a substantial advantage over the MA.

With regard to the volume that should be traded, we believe that around 20% of available capacity should be traded on this mechanism.

Ofgem's main reservation regarding this proposal is that in attempts to meet this requirement, licensees would sell at artificially high or low prices, which would reduce the robustness of reference prices. We accept that there may be a short period in which prices are artificially low, whilst the market adapts; however this will not be an enduring problem. We would like to draw a comparison with the opening of the gas interconnectors to Great Britain. This initially resulted in a drop in prices, but eventually the market stabilised and prices returned to around pre-interconnector levels. In the long term this concern is misplaced: it is up to individual licensees to manage their position across the year to prevent the need to sell a large amount at a low price or buy at a high price if they have not met their requirement. Furthermore, obliging parties to sell additional volume would not artificially increase supply; this power already exists, it is simply not made available to smaller players. Provided that there is no price regulation or collusion, high and low prices would be determined by market forces and would not therefore be "artificial".

Question 12: *Do you have any views on the design of the market making intervention outlined in this document – in particular those points listed under "outstanding design challenges" on page 33?*

Based on discussions, we understand that Ofgem is considering a general obligation to limit spreads of an individual market maker either based on a set percentage or comparisons with other market makers and other European markets. Both of these options will require significant ongoing regulation of spreads.

We do not believe that it is realistic to expect effective regulation of bid offer spreads to be possible without distorting the market. The potential for wide spreads is a fundamental flaw of the market maker and attempts to remedy this will require substantial intervention. It would be far better to choose the Obligation to Trade option, which does not require regulated pricing to be effective and works with the market rather than against it.

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Question 13: *Do you have any views on the MA design issues discussed in this chapter?*

We have no objection to the newly proposed product offerings of season +4 for baseload and season +3 for peak.

Ofgem do not appear to have addressed the main design issue with the mandatory auction: that trading activity would spike around the auction dates and distort the market. This furthers our argument in favour of a continuous exchange mechanism in line with our response to Question 11.

Question 14: *Do you believe that a hub approach to pool liquidity across multiple MA platforms is a viable option?*

No, we do not believe that a hub approach is a viable option. It would be highly complex and limit the ability to measure liquidity. It remains our position that a single platform would be better: it would limit the collateral requirements, increase transparency and make reference prices more robust. A robust tendering process for the platform provider should limit concerns that a single platform would distort competition in the market for patforms.

Conclusion and Summary

Overall Ecotricity strongly supports the move to improve liquidity in the wholesale market and believe it is imperative that changes are implemented as soon as possible.

We do not believe that the "Secure and Promote" licence condition would go far enough to make substantial improvements in liquidity and the potential for this obligation to be met through bilateral trading means that it would be difficult to monitor and have no effect on robust reference prices. A market maker obligation would not be an appropriate way of ensuring robust reference prices as it creates the potential for price fixing. We do not believe that it is possible to limit bid offer spreads without substantial intervention and price distortion. The "Secure & Promote" licence condition and the market maker options would require continued requests for information in order for Ofgem to scrutinise the detail of trades and spreads and ensure compliance. This is an inefficient route to transparency.
We strongly support the proposal for a continuous obligation to trade, but we would strongly advocate this being on a single platform decided through tender. This proposal would be more effective at improving liquidity and meeting all of Ofgem's aims. It would also have fewer distortions on the market than any other options proposed at presented.

Ofgem have expressed concerns about the fact that the introduction of an exchange along the lines of the obligation to trade or market exchange mechanism would substantially alter the architecture of the market. We acknowledge that there will be significant disruption when it comes in; however we believe this is necessary to resolve the liquidity problem.
Furthermore, unlike the "Secure and Promote" licence condition and market maker options; a continuous exchange based obligation to trade could have transparency as an embedded feature: prices and terms would be available for all to see. An exchange would allow prices to be determined by market forces and in the long run should require less intervention.

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As liquidity and the interventions needed are something that we have long advocated and engaged with, we would be happy to speak to Ofgem about this further.

Ecotricity are grateful for the opportunity to comment on this consultation on the RMR liquidity proposals and we look forward to your response and next steps.

We also welcome any further contact in response to this letter. Please contact Emma Cook on 01453 769301 or emma.cook@ecotricity.co.uk.

Yours sincerely

PP.

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