Energy UK Thought piece for the development of a framework to promote Wholesale Power Market Liquidity

15 February 2013

1. Introduction

1.1. The Energy Bill published on 29 November 2012 contained back stop clauses giving the Secretary of State powers to bring about better liquidity in the market should this be necessary. On 5 December 2012 Ofgem published a consultation *"Wholesale Power Market Liquidity: Consultation on a Secure and Promote Licence Condition"* setting out options for improving liquidity in the wholesale market.

1.2. These developments were therefore discussed at the Energy UK Board on 13 December 2012 where the decision was taken that a cross industry response should be created by Energy UK with the intention of providing solutions to the liquidity issues. This commitment was reinforced at the Industry Leaders' Forum Dinner with the Rt Hon Edward Davey MP and John Hayes MP held on 18 January 2013.

1.3. The industry wishes to find a satisfactory conclusion around the issue of liquidity. To that end Ofgem has already carried out a significant amount of work in this area and any emerging proposals need to build on this. Liquidity is only one element of a complicated policy landscape with multiple moving parts and as such should not be seen or solved in isolation.

1.4. Energy UK discussions have been held with a broad cross section of members including independent generators and the vertically integrated groups. Whilst responses to the consultation questions have also been developed, given the importance of liquidity both to industry and to policymakers, further innovative thought has been given to a number of options. These are outlined in the executive summary with further information available in the attached appendix.

1.5. It is, however, *essential* that this paper is seen as the commencement of a process as significant work is required on the detail of the various proposals, along with analysis of potential consequences and cost benefit or impact assessments before final conclusions can be reached.

2. Executive Summary

2.1. Energy UK has identified five themes for consideration either separately or as part of a package of measures. It is envisaged that some degree of co-regulation would be appropriate whereby an industry code, positioned underneath the Secure and Promote licence condition or similar, for the purposes of setting out the steps that the industry has to undertake in order to effect the requirements be created. Such a co-regulatory proposal provides the flexibility of a code but within a regulatory framework and so carries the authority of the regulator.

The five themes considered are:-

1. *The creation of a role for an independent market maker(s)* – An obligation to trade can have the effect of forcing parties to enter in to transactions that they may otherwise not have wished to undertake for a variety of reasons. Market makers are regularly used in other markets for the purposes of improving the operation of the market; lowering the barrier to new entrants; facilitating transactions; maintaining more appropriate pricing. A market maker in the context of electricity trading could well bring a variety of beneficial outcomes.

2. *A move to trading along the curve* – The requirement would be for a minimum volume traded along the forward curve expressed as a commitment to have purchased minimum volumes from unrelated parties of the corporate groups in certain products and specific tenors. A code of practice would be developed by Energy UK that would sit within the regulatory environment and which companies would be required to follow for the purposes of demonstrating that they are meeting the commitment.

3. *A restriction of self-supply* – A self-supply restriction would set out a commitment that the corporate group would be required to trade with unrelated counterparties a certain volume for delivery in any calendar year. The volume to be decided in conjunction with the regulator. A code of practice would be developed by Energy UK that would sit within the regulatory environment.

4. *A commitment to a reporting code of practice* – A code of practice would be developed for the reporting of transactions to Ofgem to demonstrate the compliance of each company with the commitment to adhere to the trading along the curve and restrict self-supply requirements.

5. *Ofgem to revisit the application of: generation licence condition 17*, - Prohibition of Discrimination in Selling Electricity for generation and supply

2.2. Whilst most members with whom we have consulted are in broad agreement with the high level themes, there are different views of the efficacy and importance of each of the five options. In addition, particularly in respect of the restriction on self-supply and the obligation to trade, there is a concern that requirements should not be seen to be specifically discriminating for or against a particular type of company.

3. Areas requiring further work

1. *Impact Assessment* – A full impact assessment needs to be undertaken to establish:
    a. The impact on consumers;
    b. The interaction with other initiatives such as routes to market;
    c. Initiatives regarding access to Power Purchase Agreements; and
    d. Areas of potential for unintended consequences.

2. *Impact of REMIT* – Whilst enhancements to transactional reporting obligations are considered as a necessary part of further work on liquidity and could be constructed via a voluntary code for the purposes of providing Ofgem details on a monthly basis of the types of trading transactions undertaken, further work is essential to understand the interaction of this proposition with the reporting requirements required under REMIT.

3. *The provision of a market maker service* – Members have identified options around the introduction of an independent market maker (or market makers) service. This, however, requires further consideration regarding scope, range of products, impact of interactions with MiFID2 provisions and financing. No discussions have yet been held with financial institutions but given the experience of market makers in other markets, this could be the preferred ultimate outcome – once liquidity has improved – to produce a sustainable market without constant regulatory intervention.

4. *Co-regulatory Arrangements* - Co-regulation is used in other markets and provides an effective outcome whereby the flexibility of an industry code sits within a statutory framework which in turn presents the requirement to comply. Work is required to determine whether the co-regulatory proposition should be in the form of service standards enshrined within a

credible governance scheme under a formal high level licence condition or whether it should be against an enshrined backstop power. A competition law review of the themes would also be needed.

4. Conclusion

This paper represents the thinking to date with further detail set out in the accompanying appendix. Next steps would include working with Ofgem in a consultative and collaborative manner to pursue the options in more depth and so determine the most appropriate routes for bringing about the best long term outcomes.

Appendix 1

Potential Themes for further investigation in relation to improved Market Liquidity

Important Caveat

Although a wide variety of Energy UK members have contributed to the development of this document not all consider that every option has equal merit. However, at this point members agree that the document represents a piece of work in progress that requires additional development and wider discussion.

Many of the ideas have not been studied in detail to assess the full impact and identify the consequences of the proposed options. As such the content is non-binding. This submission is made recognising that this is a working document of current ideas that we believe represent a useful basis for the essential discussion with DECC, Ofgem and industry in seeking a solution to improved market liquidity

Themes for further development

Energy UK has developed a potential framework to promote Wholesale Power Market Liquidity that is comprised of five themes:

1. The creation of a role for an Independent Market Maker;
2. A commitment to trade minimum volumes along the curve;
3. A commitment to a self-supply restriction;
   Note: the expectation that commitment 2 and 3 would be set out in an industry code established within the regulatory regime;
4. An enhanced reporting commitment;
5. Ofgem to revisit the application of Condition 17 - Prohibition of Discrimination in Selling Electricity for generation and supply

Each of the themes listed above is covered in depth in the following sections.

Where we refer to corporate groups we assume this covers all electricity licences that are linked by being affiliates, associates or subsidiaries of each other.

1. The potential introduction of 3rd Party Market Makers – Conditional Support by a Majority of members

Any obligation to trade may force parties to enter into transactions that they would not want to do for purely commercial reasons. This risks creating the following issues:

- Impact on Reference Prices – Forced trading activity moves market prices to a false level reducing the validity of Market Reference Prices and may increase the risk of removing true price flexibility from the market;
- Increased Costs – Increased Credit and Transaction Costs related to market activity when forced to trade outside of desired activities are passed onto the market or reduce the attractiveness of investment;
- Increased Risk – Increased Risk associated with market activity when forced to trade outside of desired activities are passed onto the market or reduce the attractiveness of investment;
- Forcing parties to trade may increase churn but it is false liquidity which is not an objective of this exercise?

If a tight bid offer spread is available to counterparties, together with small clip sizes, and this is guaranteed to be the case in future trading periods, then the issue of market access has been addressed. If nobody wants to trade in a tight market then it could be argued that all hedging requirements are being met and there is no liquidity issue.

A barrier to attracting new participants that bring new liquidity is a concern that they will not be able to close out positions at reasonable transaction costs. A Market Maker would provide comfort that positions can be closed out when required at a fixed Bid-Offer spread.

The current proposals put forward by Ofgem state that the six Vertically Integrated (VI) companies must Market Make. This has the potential to create six identical bid offer spreads in the market. Market access requires flexibility and choice. Market makers are common in financial markets. Work should be commenced immediately to determine what models would be preferable and how best to remunerate.

Ultimately Ofgem should issue an invitation to tender (ITT) inviting interested parties to begin providing the service of Market Makers against a defined specification. We believe some further investigation amongst the financial community is essential to gain experience and gauge interest.

Review
With the industry's customers paying for such a Market Maker arrangement, through the cost of the accepted offers and the provision of minimum credit lines, the benefits of the service need to be reviewed on a regular basis. The provision of the payment should initially be limited to [3] years. The payment to continue after [3] years, only if a clear benefit to end consumer can be identified.

2. A move to trading along the curve
– Conditional Support by a Majority of members

We recommend Ofgem considers securing a commitment from generators and suppliers to domestic customers to trade minimum volumes across the forward curve.

As we have not had access to Ofgem's analysis in support of the proposed value of 25% for the Mandatory Auction it is difficult to assess what types of product should be committed to. However we suggest a commitment to have traded minimum volumes from unrelated parties of the corporate group by the end of the set product periods (Yet to be determined). The proposals would go out to Season + 3.

The commitment would need to permit corporate groups, whose position relative to the reference season had significantly changed, to change their targets after first informing Ofgem of the reason. Reasons for notifying Ofgem that the targets are to be amended could be, but are not limited to:

- Generation: maintenance; asset closure/opening; changes in generation economics;

- Supply: extreme seasonality impacting demand; a significant change in portfolio size due to customer churn; a change in customer behaviour in seeking long term fixed prices;

- Uncertainty over future regulation: an example is the Carbon Floor Price beyond March 2015, currently Season +4, where the commitment to purchase for this period and beyond would have to be suspended until greater clarity is available; and

- In response to changes in the retail market.

It is essential that any commitment is allowed time to be fully realised. Therefore the commitment should be for [3] years with a review before any modification or extension. If the market maker proposal (described below) is successfully established by then, no extension would be needed.

Energy UK would develop a code of practice for trading along the forward curve, which would sit within the regulatory framework] for the companies to whom this commitment applies. This would not exclude other generators or suppliers who may also wish to sign up.

3. Commitment to a restriction on self-supply – Conditional Support by a Majority of members

The commitment could be that, in any calendar year, the corporate groups must trade a volume with unrelated counterparties that equals (or is greater than) the lower of their total domestic supply volume, less [1TWh], or their total generation less [1TWh].

Such a requirement could either be applied to all generators (with exemptions on materiality or other grounds) or only to larger VIs that supply domestic customers. We are aware that there are mixed views on the application of such a restriction and arguments would need to be explored further to establish parity and fairness. Impact studies are also required. For example, an assessment could be made of the impact of such a restriction if undertaken by corporate groups where the licenced generators together generated a total of more than [1TWh] (excluding generation for onsite consumption) in the previous calendar year, and the licenced suppliers supplied more than a specified volume to domestic customers.

There are evident potential issues for increasing price volatility to customers and particularly retail customers. This must be modelled first and the information gained used for setting the commitment parameters.

The specifics of the commitment may need to be tailored for each company in accordance with the precise nature of its business.

In addition, in order to ensure that credit arrangements remain robust and fair periodic reviews of the impact of this proposed commitment would be required. For the avoidance of doubt, this arrangement must allow for individual licences who trade via a separate trading business (related or non-related) to continue to do so, provided the spirit of the commitment is protected.

Energy UK would develop a code of practice to cover provisions around a commitment to restrict self-supply, which would sit within the regulatory framework for the companies to whom this commitment applies. This would not exclude other generators or suppliers who may also wish to sign up

4. Commitment to a Reporting Code of Practice – Conditional Support by a Majority of members

Depending on the outcome of Ofgem and Industry discussions around the reporting requirements necessary to support REMIT provisions Energy UK will develop a code for reporting of transactions for all of the larger generators and VIs that are participants in the self-supply restriction and the commitment to trade along the curve. This would not exclude other generators or suppliers who may also wish to sign up. Voluntary code signatories would commit to providing information to Ofgem that demonstrated their compliance with the commitment restricting self-supply and to their adherence to the trading along the curve. The reporting would be subject to audit to validate the data.

It is recognised that there are business confidentiality issues arising from such a reporting commitment and therefore all relevant trades could be submitted on an agreed basis to Ofgem under a confidentiality arrangement.

At the end of each trading year, confirmation of relevant trades for meeting the requirements of the generation and supply licence restrictions on self-supply and the commitment for trading along the curve would be provided to Ofgem.

5. Ofgem to revisit the application of Licence Condition 17 for generation and supply – Conditional Support by a Majority of members

The existing Generation Licence Condition 17 - Prohibition of Discrimination in Selling Electricity if applied to all generation and supply licences, would be less subjective, wider and a more satisfactory solution than a requirement to offer fair and reasonable terms when negotiating trading agreements. The principles of Generation Licence Condition 17 should be incorporated in the supply licences, with the condition applicable to all generation and supply licences.

Appendix 2

Q1 Do you agree with our assessment of market developments? **Q2 Do you agree with our description of the policy and regulatory context affecting liquidity?**	A Liquid market could be defined as one which provides the ability to enter into and exit from long term trades. The metrics appear to be realistic but is it appropriate to compare liquidity within the electricity market with liquidity within the gas market which operates under very different conditions? Members were split over where a comfortable level of 'churn' would be and the point at which Ofgem would perhaps feel it appropriate to remove the Licence Condition. Season plus four may appear the limit given the current uncertainties in the market around for example the reforms within the Electricity Market and electricity cashout. It was also observed that large Suppliers only hedge 18months out (as outlined in the Ofgem Retail Market Reform findings) so industry would not expect to trade beyond Season plus 4.
Q3 Are there other factors that we have not identified that may be posing a barrier to improvements in liquidity?	Members are generally comfortable with the provisions in figure 11 page 27 however open ended requirements which may be subject to future change are a concern. Members would be supportive of including provisions within a Licence Condition provided it is clear how Ofgem expects to measure 30% of generation etc. It was noted that the calculation for Community Energy Savings Program (CESP) may provide a basis for the identification of such a value.
Q4 Do you agree that the Secure and Promote model presented in this document could help to meet our objectives?	The concept may be acceptable however this should be achieved via a Licence Condition. The 'Secure' aspects within the proposal appear to be sound however the 'Promote' provisions are less clear and not sure to deliver liquidity as this concentrates only on the offer aspects of trading. More detail would be appreciated as members were not sure that all relevant information has been presented within this consultation document. The question around how Ofgem would assess success here was also raised. For example is it spot on 30% or somewhere near to this value? Members also questioned what the process might be for changing this value if the market does not achieve 30% but the pricing is robust?

Q5 Does our proposed structure for Secure and Promote seem appropriate?	
Q6 Do you think the proposed Secure and Promote Model would be a more effective intervention that the Mandatory Auction?	Members have concerns about the introduction of a Mandatory Auction (MA). Members' preference was for a regime which provided for continuous liquidity rather than the sporadic volumes perceived to be available via the MA approach.
Q7 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?	Members observed that smaller Clip sizes are offered now but rarely traded. The definition of products may be problematic as may not be able to produce exact shape etc but accept that standardised baseload and peak would be possible. Further investigations and modelling would be required in this area in order to clarify what is meant by the Product Range? In addition further discussions around how participants would be monitored against this element would be appreciated. As stated above, any Licence Condition should be well defined and include an outline of governance provisions with a possibly of including a sunset clause if a target is reached. Clarification around what the intention of what is fair and reasonable would also be appreciated. It could be possible to deliver against this element if we reference a suitable market index but further work around how to develop a recognised market index is required. Credit and Collateral rules would need to be clarified. Response to trading requests looks like a reasonable aspiration. However members need to understand the rules around introduction and transition, particularly if, on day 1, several requests are received. There would also need to be a monitoring of performance against a 20 day response and see if this was reasonable or if perhaps this would need to be adjusted upwards to say [25]. In order to facilitate transparency the methodology and rules should be published. There was agreement around the scope of the proposals however there was consensus that this should be broadened to state that the Licencee (generation or supply) will reflect these characteristics in all trading agreements regardless of size or type of participant. This statement is made against the Ofgem requirement '*to limit this to independent suppliers < 1MW'*. This is a flaw in the whole consultation.

Q8 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?	This must be undertaken on a recognised platform Regarding volume – Up to 30% is acceptable Members would be comfortable if the numbers are clearly set out in the Licence.
Q9 Will trading along the curve naturally develop from the near-term market?	There are a variety of views amongst members Due to several developing initiatives in support of Electricity Market Reform it is difficult to provide an answer to this question with any certainty as there are just too many unknowns at present.
Q10 Should Ofgem intervene to ensure that robust reference prices along the curve develop?	There are a variety of views amongst members
Q11 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?	The Market Maker option was the one which attracted most conditional support from members however further work would be required to develop an appropriate approach for full assessment prior to being adopted. Members also recognise that MiFIDII, EMIR and FSA requirements could be a potential problem.
Q12 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?	Once issues around the interaction with FSA and EU rules have been thoroughly investigated and resolved this would be an option worth considering. The issue of affordability should be factored into the Cost Benefit Analysis. Plus the issues around the amount of additional collateral that would be required.
Q13 Do you have any views on the Mandatory Auction design issues discussed in this chapter?	There was little support for this option
Q14 Do you believe that a hub approach to pool liquidity across multiple Mandatory Auction platforms is a viable option?	A Hub approach may be possible but linking different products and different platforms will not be a simple task. Individual procurement resulting in several platforms would be a complex and costly approach. One central hub may provide an acceptable solution provided a range of products are offered. There are several routes to market, including the OTC, which also need to be retained and not adversely impacted. If 25% is introduced will platform(s) need to be developed? What is the proposed approach? Do not go down the 6 different platform route to facilitate trades. Would Ofgem procure this platform?

AOB	The consultation suggests that a Licence Modification(s) decision would be made ahead of summer 2013 with Licence Conditions introduced by end 2013. Is this timetable feasible and appropriate given that there are many moving parts which could affect market liquidity occurring outwith the scope of this consultation?