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Dear Mr. Slarks,

## **Wholesale Power Market Liquidity: Consultation on a “Secure and Promote” licence condition**

### **Chapter One**

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

We agree with Ofgem’s conclusion that churn has continued to deteriorate in the UK electricity market and believe this is a key indication of the entrenchment of worsened liquidity within that market. In 2002 churn was roughly a factor of seven, while today it is closer to a factor of three, a drop of over fifty percent in a ten year period. Our view is that this is largely a result of the vertical consolidation of generation with retail businesses in the UK electricity market. Vertical integration and its associated detrimental impact on liquidity is a rational economic consequence of some of the original wholesale market design features under NETA, particularly the punitive imbalance regime, which created a clear economic benefit of coupling generation with retail. This, combined with the withdrawal of many liquidity providers (including American wholesalers such as AEP, Dynegy, El Paso, Duke, Williams, Reliant etc) has led to the low liquidity and stagnation currently observed in the UK wholesale electricity market. We believe that the only way to reverse this trend of lowering liquidity is through a significant regulatory intervention that drives a significantly increased need to trade by upstream and downstream players. We believe that current trading activity is based more on a ‘want’ rather than a ‘need’ to trade, which is not a strong basis for robust wholesale market price discovery, is not based on vigorous supply and demand, and seriously undermines confidence in the traded wholesale market. Lack of liquidity forms a key barrier to new entry and competition, which is not in the consumer’s best interest. We believe that the success of EMR will also depend on a significantly more liquid wholesale market, in particular to ensure that the index prices for CFD FITs, which will be used to settle billions of pounds of renewable and nuclear subsidies each year, are robust and not gameable.

While short dated forward electricity products remain relatively liquid, there is still a significant lack of liquidity in products further along the forward curve from front season onwards and we note that Ofgem have stated that trading of products more than 24 months out has continued to decline. Of particular concern is the lack of ability to forward trade shaped products and flexibility, where we note that availability of even the most basic seasonal forward peakload products has seriously deteriorated. We agree that bid-offer spreads remain wide, particularly in comparison to the gas market, and feel that this is a further indication of lack of activity in the trading of certain products. More frequently wide bid-offer spreads are a symptom of low liquidity but we note that they are not the problem itself as they can occur even in liquid markets at times of higher price volatility.

We do not agree with Ofgem that liquidity in short term products is necessarily linked to liquidity further forward. Short term trading volumes are based on supply and demand changes close to

delivery due to out-turn weather, plant availability, plant outages and short term fuel supply chain issues for thermal plants (that drives short term availability of the fuels and their prices). In contrast, trading further forward is based on supply and demand for forward delivered products, which is driven by the need to hedge generation output further forward in order to lock in generation returns for plant owners, and the need to hedge retail portfolios ahead of delivery in order to lock in retail margins. We would expect liquidity to be healthy in short dated forward products as players have a need to fine tune their positions close to delivery in reaction to the real time issues described above, and most participants are not concerned about the short term market.

The ability to hedge further forward is the main issue that needs to be tackled by a liquidity intervention. Independent suppliers such as First Utility are greatly disadvantaged at present in relation to the lack of liquidity and lack of robust price discovery in longer term standard and shaped products. In contrast, integrated suppliers are protected from this issue to a large extent through the availability of internal generation output that acts as a natural risk mitigant for these wholesale market issues, even though such solutions exacerbate the issue for those not operating within an integrated utility business model.

We do not believe the lack of liquidity further along the forward curve is mainly the result of credit concerns, but due to a lack of need to trade driven by the structure of the players in the market. We believe that in a liquid market with robust price discovery it is market intermediaries who normally provide innovation around the warehousing of risks (market price, volume and credit risks) for smaller and new entrant participants both upstream and downstream. The reduction of participation of market intermediaries is a symptom of the integrated structure of the generation players in the market, and this results in a detrimental impact on liquidity.

Against this background to the liquidity issue, First Utility does not believe that the Mandatory Auction or the Secure and Promote proposals are sufficient to drive the step change in liquidity that the UK wholesale electricity market requires. We believe that these proposals will be complicated to design, implement, monitor and enforce, will be expensive to run, and have unproven benefits. We believe that the best and simplest solution to promote liquidity would be a Self Supply Restriction (SSR) on vertically integrated incumbent participants. Such a solution focuses not on the specific detailed trading activities such participants must undertake, but it instead describes the one activity that those participants cannot undertake: internal energy transfers. This leaves the integrated utilities free to sell their generation output when they like, to whom they like, under credit and price terms they commercially agree with third parties. This does not artificially force liquidity, but instead ensures trading is based on supply and demand fundamentals along the forward curve.

Requiring integrated utilities to sell all of their generation output into the forward traded market will immediately drive a need for their supply businesses to source shaped products from the market to hedge their retail portfolios too. The resulting price discovery on generation output and retail shape would lead also to product discovery and a rapid and beneficial step change in liquidity. An SSR could be easily monitored by restricting the movement of power from those companies' production to consumption accounts. Finally, we note that Elexon would hold data on the level of any ECVN and MVRN activity between the consumption and production settlement accounts of integrated participants, which would be helpful data enabling Ofgem to form an accurate picture of the historic evolution of the level of internal volume transfers in such utilities. We believe this would likely be a very useful indicator as to the reasons for low levels of liquidity in the UK wholesale electricity market and would provide another view to compare against claims by some incumbent utilities that they already dispatch 100% of their generation portfolio into the wholesale market.

We note that at the recent Ofgem liquidity roundtable events, there was a significant level of discussion around Self Supply Restrictions as an alternative to Mandatory Auctions and 'Secure and

Promote' proposals. We believe there is a great deal of appetite across many market participants for such an intervention.

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

Yes, to some extent, although please see our answer to Question 1 above.

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

As discussed in our answer to Question 1, we believe that lack of liquidity is largely driven by vertical consolidation which NETA incentivised via the economic signal from the punitive dual-priced cashout regime. Pairing generation with supply is the most rational economic way to protect against risk at cashout, but is achieved with the side effect of a reduced need to trade and the resulting low liquidity currently found in the UK electricity market. A significant intervention is required to solve these issues and restore healthy wholesale competition.

## **Chapter Two**

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

'Secure and Promote' may have some small effect on liquidity, but we do not believe that it will be a significant enough intervention to drive the step change required. We believe a Self Supply Restriction on incumbent integrated utilities is the only way to meaningfully drive up electricity wholesale market liquidity. We make the following observations in relation to driving up liquidity along the forward curve:

- We believe that a market making obligation will not drive a meaningful increase in forward trading unless it is mandatory for a far higher percentage of the time than proposed by Ofgem.
- Bid-offer spreads 'not excessively wider than the market' does not drive bid-offer spreads narrower, but could instead lead to the opposite: the mandated players may chase the other mandatory bids and offers ever wider, which would be allowed under Ofgem's proposals. Mandating maximum allowed bid-offer spreads might alleviate this risk, though we see mandated maximum levels of bid-offer spreads as difficult to assess, implement and monitor.
- This would not be naturally occurring liquidity based on supply and demand fundamentals driven by natural competitive forces of generators and suppliers competing. This instead would drive liquidity outside of normal cycles of hedging activity – potentially leading to more irrational price volatility and unintended consequences.
- There are monitoring issues – we believe it will be complicated and very expensive to check whether a mandated player has bid or offered for the correct amount of time, in the mandated products, at the mandated transaction sizes, at the mandated bid-offer spreads, across all the UK wholesale electricity marketplaces.
- We believe that mandated players are likely to need to curtail trading activity at other times in the market in order to manage a mandated market making obligation. This will lead to the risk

that volumes are simply transferred from one pool of liquidity (or time of liquidity) to another, with no net increase in liquidity across the UK wholesale electricity market as a whole.

In relation to securing short term liquidity, we believe the definition of 'fair and reasonable terms' when negotiating trading agreements is open to wide interpretation and is likely to result in little benefit to the players Ofgem seek to assist. We believe that fair and reasonable trading terms should develop naturally in a wholesale market that is liquid and has a large number of physical and financial participants.

We are not convinced that the evolution of greater liquidity in the near term market will necessarily translate to an equivalent degree of liquidity at the far end of the curve. The market intermediaries who might trade the forward market do not do so in order to take a position to delivery, they do so mainly with the intention of 'closing out' their forward position at opportune moments far ahead of delivery. 'Value at Risk' (VaR) limits and credit limits would restrict the ability to hold significant forward positions all the way to delivery.

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

We do not agree that Secure and Promote will appropriately address wholesale electricity market liquidity issues. If Ofgem did decide to implement a form of Secure and Promote, it would need far tighter controls on market spreads and on the percentage of time that market making was mandated for the mandated participants in order to drive any meaningful increase in liquidity.

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

We do not believe that one is necessarily any better than the other. A Mandatory Auction will simply move liquidity from the current market place into the MA, fragmenting and not increasing liquidity. Secure and Promote is also, in our view, likely to be ineffective in solving the liquidity problem. See our general answer to Question 1 which outlines why the SSR is our preferred option to drive enduring liquidity into the UK electricity forward wholesale market.

## **Chapter Three**

***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?***

Although these seem reasonable in theory, we would suggest that it would be at worst almost impossible and at best extremely expensive for Ofgem to monitor compliance with these. We also feel that this cost and complexity would outweigh any benefit likely to be provided by implementation of this proposal.

***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 would like to reiterate our view that the near term traded market is not where the liquidity problem is. Rather, smaller suppliers have difficulty accessing products at the far end of the forward curve, and the issue is more serious for forward shaped products. We are not convinced that a robust near term market will eventually stimulate liquidity further forward. We outline some reasons in our answer to Question 4.

## **Chapter Four**

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

We do not believe so. Please see our answers above, including our answers to Questions 1 and 4.

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

Yes, however, First Utility does not believe that the MA or Secure and Promote proposals will be successful liquidity interventions. As stated in our answer to Question 1 above, First Utility is of the opinion that a Self Supply Restriction would be the simplest to implement and monitor and would naturally lead to greater liquidity without the requirement for further intervention.

### ***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?***

As with the Mandatory Auction proposal, market making will simply divert liquidity away from current trading activity, fragmenting it across more traded marketplaces, so that the overall level of liquidity across all of the UK electricity trading marketplaces remains largely unchanged. This fragmentation of liquidity is likely to further undermine the wholesale electricity market price signal.

### ***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?***

Please see our answer to Question 11 above. We agree with Ofgem that mandating bid-offer spreads, should the market making proposal be implemented, would be likely to lead to price distortions, but we also see that not mandating bid-offer spreads undermines the intervention from the perspective of increasing volumes traded. Given these and other serious complications to the proposal, the alternative of a Self Supply Restriction would avoid these complications as it would boost traded volumes in the market without the need to artificially enforce constraints around bids and offers.

## **Chapter Five**

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

Please see our answers to the Questions above. A Mandatory Auction will simply divert liquidity from the current trading platforms into the auction platform, with little or no overall increase in liquidity. In addition, a Mandatory Auction is likely to be expensive to implement and administer and credit and collateral requirements may bar smaller players from effectively participating. We do not believe the MA or Secure and Promote can deliver sufficient increases in liquidity to encourage the re-entry of market intermediary participants who can innovate around credit and warehouse market price and volume risks for other market participants.

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

We do not believe that increasing the number of marketplaces to trade is a solution to the liquidity problem. Current levels of trading activity reflect the current lack of need to trade, not a lack of



marketplaces to trade. The liquidity problem is a reflection of the structure of the players in the market. When the suppliers to 99% of retail consumers in the UK also own approximately 80% of generation in the UK, this leads to a natural reduction in the need to trade. We would like to reiterate our view that a Self Supply Restriction, monitored and enforced by restricting ECVN and MVRN activity between obligated participants' production and consumption accounts, is the simplest and most effective way to boost liquidity in the power market along the forward curve.

Please do not hesitate to contact Jonathan Smith ([jonathan.smith@first-utility.com](mailto:jonathan.smith@first-utility.com)) or myself ([chris.hill@first-utility.com](mailto:chris.hill@first-utility.com)) should you have any questions or require any further information.

Yours sincerely,

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