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Dear Phil,

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

Thank you for the opportunity to provide views on your consultation paper on the introduction of a 'Secure and Promote' licence condition, as a means of improving wholesale power market liquidity. This response is provided on behalf of National Grid Electricity Transmission plc (NGET) and is not confidential. National Grid[1] owns and operates the high voltage electricity transmission system in England and Wales and, as National Electricity Transmission System Operator (NETSO), we operate the Scottish high voltage transmission system.

In the UK, our primary duties under the Electricity Act are to develop and maintain an efficient network and to facilitate competition in the generation and supply of electricity. Our activities include the residual balancing in real time of the electricity system.

NGET is prohibited by its licence under the Electricity Act from purchasing or otherwise acquiring electricity for the purpose of sale or other disposition to third parties, except for limited system or balancing activities prescribed in the commercial arrangements. As a result, NGET is not a significant participant in the forward wholesale power markets in Great Britain. NGET's limited role tends to be restricted to prompt trading patterns in order to ensure the residual balancing of electricity supply and demand and manage system security. In the financial year 2011-12, National Grid traded 3.088TWh in the Over the Counter market through a combination of non-locational trading and actions taken with specific BMUs. These trades were undertaken for both energy balancing and system management purposes and were generally taken less than a week ahead of delivery. To put these trades in perspective, around 300TWh of electricity is transmitted annually in the UK and, using Ofgem's estimated churn of 5 (i.e. total trades ≈1500TWh), our trades make up around 0.2% of the total trades. However, we believe there are interactions between the near-term and longer-term markets and a robust short-term price could have a favourable impact on the prices further along the curve. We are therefore supportive of Ofgem's initiatives outlined in this consultation as these aim to promote liquidity in all timescales.

[1] In this response, National Grid and NGET are used interchangeably.

Summary

National Grid agrees with Ofgem's overall assessment that, whilst there have been some improvements in wholesale power market liquidity (e.g. trading commitments by some large suppliers), the progress has been limited.

The proposed Secure and Promote model builds on existing developments (e.g. by formalising trading commitments made by suppliers in a licence condition) whilst seeking further improvements in liquidity. National Grid considers that it is prudent to continue to build on existing improvements rather than pursuing a more interventionist approach such as Mandatory Auctions (MA), but retaining MA as a back-up option.

National Grid also agrees that the initial focus of the liquidity project should be on the 'big 6' who control 99% of the domestic market and 70% of the generation market (as outlined in the consultation). Whilst we can see the reasoning for initial focus on these licensees, 30% of the generation market is controlled by other licensees and this is a significant proportion of the total generation; our view is that there may be merit in including all generation in the future.

National Grid considers that the overall requirement for the licensees to offer fair and reasonable trading terms and high level details around them (e.g. product range covering both baseload and peak at various points ahead of time, transparency of pricing methodology) could lead to improvements in liquidity. Similarly, the requirement for licensees to trade at least 30% of annual generation in the near-term could also enhance liquidity, particularly if the trading is conducted on a single platform. The development of a GB Hub by National Grid Interconnectors Limited and BritNed under the North West Europe (NWE) Market Coupling Project should have a positive impact on the GB liquidity. New entrant platforms that connect to the GB Hub would also be able to access the single GB pool of liquidity. These requirements, combined with the development of the GB Hub, could reduce barriers to entry and benefit smaller independent parties.

The remainder of this response in the Appendix provides our thoughts in relation to the specific questions asked within the consultation document.

If you wish to discuss the content of this letter further or have any queries, please contact Ian Pashley on 01926 653446 in the first instance.

Yours sincerely

Mike Calviou
Director of Transmission Network Service

Appendix: Responses to questions raised in the consultation

CHAPTER ONE: Context and market developments

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

National Grid agrees with Ofgem's overall assessment that, whilst there have been some improvements in wholesale power market liquidity (e.g. trading commitments by some large suppliers), the progress has been limited.

In the near-term market, physical players have an inherent incentive to balance their supply and demand position in order to meet their contracted positions and avoid any imbalance charges. This, along with the recent publicity around this topic and the associated response by the vertically-integrated parties, may have contributed to the development of the near-market market (liquidity objective 3). However, there may be less of an incentive to trade in the longer-term markets and this may explain the lack of progress further along the curve such as lack of robust reference prices (liquidity objective 2). As noted above, developments such as trading commitments by suppliers may lead to greater availability of products which support hedging (liquidity objective 1) but further work is required to achieve this goal.

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

National Grid agrees with the policy and regulatory context described in the consultation, and considers that any project which alters the fundamental aspects of the market operation will have an impact on liquidity. This includes the projects outlined (Electricity Market Reform, relevant European legislation such as REMIT, wider European Target Model, and Electricity Balancing Significant Code Review) which could have an impact on the liquidity in the GB wholesale power market.

In addition to the above, National Grid considers that the context should also include intermittent generation. As wind penetration increases, it will become increasingly important for market participants to be able to effectively balance their positions, which would assist National Grid in managing residual system balance in an economic and secure manner. A more liquid market could help achieve this aim. Intermittent generators will benefit from increased liquidity in the prompt market to enable them to balance surpluses and shortfalls in output. The ability to balance close to real time could become increasingly important for non-portfolio players in light of any changes to imbalance charging through the Electricity Balancing Significant Code Review. Should a liquid near-term market lead to more robust prices along the curve, then this would also assist these smaller players by increasing the opportunity to engage in more financial hedging contracts.

The context for the regulatory debate should also take into account the current state of the GB market. As highlighted in Ofgem's segmental analysis[2] for the year ending 2011, the big six integrated companies in aggregate control 70% of the generation market. However, there is a marked difference between their generation and supply portfolios. Of the big six companies, 4 (across the year) have supply electricity commitments greater than generation, 1 is almost equally matched whilst there is only 1 for whom generation exceeds annual supply. 4 are thus net annual purchasers of electricity with only 1 a net seller. Whilst near-term trading is likely to be driven by short-term trading requirements

2 http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Reporting%202011%20Results%20Overview%20text.pdf

(demand, portfolio generation availability, prices etc), longer-term trading is likely to be driven by the underlying requirements and trading strategy of the business. The shortfall for those suppliers who are net buyers may have been procured via bilateral contracts, which may have had an unfavourable impact on the development of long-term trading.

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

National Grid considers that the key factors posing a barrier to improvements in liquidity have been identified in the consultation.

CHAPTER TWO: The Secure and Promote Licence Condition

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

National Grid considers that the Secure and Promote (S&P) model could help meet liquidity objectives.

The S&P model builds on existing developments (e.g. by formalising trading commitments made by suppliers in a licence condition) whilst seeking further improvements in liquidity. The licence requirements, including regular reporting on compliance with these requirements, have the potential to improve liquidity which could be further enhanced by innovative approaches that may evolve from such a market-based model (as compared with a more interventionist Mandatory Auction model). However, the success of this model is likely to depend on the extent to which non-compliance is measurable and, if a licensee is found in breach of the S&P licence condition, the strength of enforcement actions that could be available to, and deployed by, Ofgem.

The initial scope of the S&P licence condition is the 'big six' vertically-integrated companies[3]. Given that these companies control 99% of the domestic supply market and 70% of the generation market (as outlined in the consultation), National Grid agrees that the initial focus should be on these licensees.

Whilst we can see the reasoning for initial focus on these licensees, 30% of the generation market is controlled by other licensees and this is a significant proportion of the total generation; our view is that there may be merit in including all generation in the future.

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

The S&P legal structure outlined in the consultation seems appropriate. However, as highlighted in our response to Q4, the success of this structure is likely to depend on the enforceability of the S&P licence condition.

The proposed obligation on a licensee to buy and sell 30% of its generation on the day-ahead auction platform seems to be limited to short-term trading. It may be appropriate to also apply this restriction to longer timescales which would not only ensure consistency across shorter and longer timescales but could also have a favourable impact on discovering a robust reference price along the curve (liquidity objective 2).

[3] Centrica, EdF energy, E.ON, RWE Npower, Scottish Power, and SSE

From the consultation, it is not clear how the 30% threshold is derived. It would be useful to clarify the rationale for this threshold as this could be important if the current proposed level is not considered appropriate (e.g. if it is deemed that it is not delivering sufficient liquidity).

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

Traded volumes are likely to be more transparent under mandatory auctions than S&P model, negating the need for detailed reporting that could be required under the S&P model. Greater transparency under mandatory auctions could also reduce barriers for new entrants and independent generators which could improve liquidity. However, the S&P model builds on positive market developments such as progressively improving day-ahead trading and is, in our view, a more pragmatic approach. It would therefore be prudent to continue to build on these improvements via the S&P model. We consider the S&P model a more effective intervention than Mandatory Auctions. However, the Mandatory Auctions should remain a backup option if the S&P model does not meet the liquidity objectives; a time limit may need to be set for S&P to deliver the liquidity objectives before pursuing a Mandatory Auction intervention.

CHAPTER THREE: Securing existing developments

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?

National Grid considers that the overall requirement ("The licensee must offer fair and reasonable terms when negotiating trading terms") seems a step in the right direction and could help achieve the objective of "availability of products which support hedging" (liquidity objective 1). The detailed illustrative requirements (e.g. product range covering both base-load and peak at various points ahead of time, and transparency of pricing methodology) outlined in the consultation would provide further clarity for both vertically-integrated players and independent parties in negotiating the trading agreements.

Due to our licence requirement to operate the system economically and efficiently, National Grid is present in the prompt and near curve markets. The changing nature of the electricity transmission system and the associated requirements placed upon us as System Operator mean that our trading focus is primarily between week ahead and intraday markets. To date, our traders have been able to procure the contracts required to operate the system efficiently; however, anecdotal evidence would suggest that OTC volumes have been decreasing in recent years. It is also noted that volumes in the Day Ahead auction have increased significantly.

Whilst access to shaped products may be the preference of smaller parties, additional complexity will be introduced by mandating shaped products. Our view is that, to minimise the impact on licensees, only standard products should be mandated.

With regard to the outstanding issues on Credit and Collateral arrangements, these should be left to the counterparties involved; any reporting mechanism concerning each licensee could potentially include high level details of the volumes of trades involving smaller parties, including credit arrangements. More liquid exchanges could also assist smaller parties by reducing the number of Grid Trade Master Agreements (GTMAs) required to gain access to a wide market.

In addition to considering the requirements and benefits for independent suppliers, it may be appropriate to include independent renewable generators in these considerations and how the routes

to market for these generators could be improved. For example, some renewable generators have highlighted the restrictions some Power Purchase Agreements (PPAs) place on reducing generation for commercial purposes via the Balancing Mechanism. As the penetration of renewable generation increases, the importance of a liquid day ahead and within day market is also likely to increase. It may therefore become important to consider near-term trading products that are based around the physical energy provided by intermittent generation.

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?

The illustrative day-ahead requirements such as gross bidding (trading on both the buy and sell sides of the market) and trading at least 30% of annual generation should help towards achieving the liquidity objective of an effective near term market. With regard to the outstanding issues on day-ahead auction platforms, National Grid's views are provided below:

Impact of gross bidding: National Grid agrees with the suggestion that increased trading activity from gross bidding could contribute to robust price discovery in the near-term market, and could subsequently improve liquidity along the curve in the longer-term markets (thus meeting liquidity objective 2). Trading on both sides of the market could also help participants to refine their positions. Availability of increased volumes in both directions could allow National Grid to better manage short and long system imbalances.

Trading platforms: National Grid Interconnectors Limited and BritNed are in the process of developing a GB Hub with the aim of pooling liquidity between the two GB day-ahead auctions, (N2EX and APX-Endex), as part of the North West Europe (NWE) Market Coupling Project. The NWE project will integrate the day-ahead auctions of 13 countries and as such will have a positive contribution to GB liquidity. A particular benefit of market coupling is that it brings competition around the marginal price, whereas gross bidding brings additional volume but not necessarily at the margin, particularly when there is an obligation to buy and sell a certain volume.

In addition, the introduction of the GB Hub will ensure that there is a common pool of liquidity in GB, (trading at a common price), that participants on either of the two platforms can access. Competition between the GB platforms will therefore remain, but the combined pool of liquidity across the NWE region can be accessed from either platform. New entrant platforms that connect to the GB Hub would also be able to access the single GB pool of liquidity.

Level of traded volume: National Grid considers that, as a starting point, it is reasonable to include the 30% threshold for trading of annual generation volume. As stated in the consultation, it would be prudent to keep this threshold under review once the licence obligation is in place. Our comment in response to Q5 regarding the rationale for the 30% threshold may also be helpful.

CHAPTER FOUR: Promoting further developments

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

Although, in its role as a residual balancer, National Grid is mainly active in the near-term market for managing short-term system imbalances, we consider that a successful near-time market would be a sound basis for the longer-term markets; for example, a robust near-term price with small bid-offer spreads could form a useful reference for longer-term trades.

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

Ofgem intervention should be kept to a minimum. It is not clear if the proposed intervention will lead to robust reference prices along the curve. The consultation document highlights the progress that has been made on some aspects of Ofgem's objectives and these should be further developed before additional intervention is considered.

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?

Please see response to Q9.

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 response to Q9.

CHAPTER FIVE: Update on the Mandatory Auction

Question 13: Do you have any views on the MA [Mandatory Auctions] design issues discussed in this chapter?

National Grid understands that the key MA proposal is to oblige parties to auction 25% of their generation in longer-dated products (from one month ahead to several seasons ahead) each month. As stated in response to Q9, National Grid is not a significant party in longer-term markets and has insufficient knowledge to provide substantive comments in this area.

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

National Grid considers that a hub approach to pool liquidity across multiple MA platforms could be a viable option.

National Grid understands that the Mandatory Auctions could be hosted on either a single platform procured by Ofgem or on several platforms individually procured by each obligated party. For the latter option, trading on multiple platforms could be brought together in a unified auction process by a 'hub'.

The choice of a single or several platforms is likely to depend on the relative costs and benefits of the two options and their effectiveness to deliver the liquidity objectives. Use of multiple platforms may lead to lower trading fees as a result of competition between the platform providers. However, combining multiple platforms in a single hub would be preferable because this could not only reduce opportunities for any price manipulation across multiple platforms but could also improve transparency (relative to multiple platforms), leading to favourable impact on liquidity. The concept of a single hub is also consistent with the GB Hub which is currently being developed by National Grid Interconnectors Limited and BritNed for day-ahead auctions, as part of the North West Europe (NWE) Market Coupling Project.