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

Dear Phil,

SmartestEnergy welcomes the opportunity to respond to the call for evidence on wholesale power market liquidity as this is an issue which we have been following closely and engaging in discussion for some time now. Our organisation relies on the wholesale market; therefore we are keen that it is as effective as possible.

In summary, we are pleased that Ofgem are considering alternatives to the MA as we believe this intervention would not only be unhelpful but also potentially detrimental to the wholesale power market for reasons which we have previously made clear and refer to for specific questions below. The market making obligation is a more welcome initiative and our support for the Secure and Promote licence condition proposal as a whole is conditional on its inclusion and the re-evaluation of the other sections. The addition of an obligation to trade will improve the effectiveness of the market making obligation and mitigate the need to regulate bid-offer spreads.

By far and away the most important aspect of wholesale trading which needs to be fixed is for the market to appear liquid. In other markets this would be seen through companies voluntarily making markets. The Mandatory Market Making solution will create a market which has been suppressed due to vertical integration. We are not convinced that the suggestion at the recent workshops of a third party taking on the MMM service for a fee is either workable or appropriate; tendering for new institutions is, in our view, a greater intervention in the working of the market than encouraging existing players to behave as if there were a market.

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At recent discussions it has been suggested that if smaller players were really interested in trading they would put numbers up. I would like to take the opportunity to counter this argument. In reality, when we have put up numbers we either get no response or a bid/offer is put up against us with a derisory spread. So if we do eventually trade we know we are giving substantial value in doing so. Quite often others will then recognise this but be unwilling to show any numbers until after it has traded and this additional interest is only at the same derisory levels.

We are unable to see how forcing the large companies to offer fair and reasonable trades bilaterally to certain companies is beneficial for the wholesale power market liquidity when it is likely to reduce liquidity, market transparency, is discriminatory to other players and as such could put off new entrants (for example, financial players). Also, with regards to the other feature of the proposal, we are not concerned by the voluntary nature of gross volume commitments as day ahead liquidity was not a concern previously and market forces should work to encourage continued liquidity on day ahead, especially if the CfD reference prices are set to day ahead markets. For the forward market to improve though, regulatory certainty is needed which could take the form of a commitment to have long lead in times on policy of at least 2 years.

We have noted with interest the discussions during the roundtable events regarding the self-supply restriction option for intervention which we have previously supported. If this was to be progressed we think that there may be merit in exploring a restriction on Energy Contract Volume Notifications (ECVNs) between accounts which would increase transparency and liquidity without having to segment Vertically Integrated companies. In the spirit of non-discrimination we would be in favour of this applying to all in the market.

Finally, we would like to draw Ofgem's attention to work under way at the products at FOA to move away from the EFA Calendar. We believe there is a danger that the products being proposed in this area may not be aligned with Ofgem's list of products and we would encourage Ofgem to take an interest in developments.

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

> For objective one we understand that the fair and reasonable trading terms are not necessary exclusively for bi-lateral trades we would like to point out that improving bi-lateral arrangements does not improve liquidity nor does it improve the availability of products to support hedging for <u>all</u> players in the market. On the contrary it reduces both liquidity and transparency. We are still finding it difficult to

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access all the products we require to hedge shape along the curve i.e. peaks and extended peaks in the months and particular seasons ahead. However, we are not seeking special treatment as we believe it is more beneficial to improve the wholesale market for all rather than improve routes around it. There was a step change for the worse in liquidity when EMR was announced so we believe that Ofgem is correct when they attribute some blame to policy uncertainty for longer dated products.

With regards to the second objective for robust reference prices we believe this should not be an objective in itself. This is because non-robust reference prices along the curve are a symptom of poor liquidity, not a concern in itself and not something that we are seeking when using the market. If we take this objective to represent longer-term liquidity then we agree with the assessment that there has not been much improvement.

We agree with the assessment with regards to the near-term market. However, liquidity in the day ahead market was previously not a problem anyway and sadly further volume has not led to additional liquidity down the curve. Forcing the large suppliers to maintain large volumes of trades on day ahead markets will not help the potential of liquidity to develop along the curve.

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

We anticipate that CfDs will increase and concentrate liquidity around the choice of reference price, though the extent of this concentration will depend upon the timing and number of projects which sign CfDs. As long as parties can access the platform which determines the reference price it should be robust and liquid.

With regards to regulatory uncertainty, we understand that due to the complexity of the industry (with the plethora of changes occurring at present) it is difficult to maintain a sense of stability and certainty for parties, especially as the impact of the European integration project is something which government cannot fully control (and the impact of which is uncertain although we expect European market integration to have a positive effect on liquidity). Regulatory uncertainty is a huge problem for the market though. The carbon price floor is not fully priced along the curve and only a handful of companies will trade far out.

One way of not affecting liquidity on the forward market is to be firm that any changes to the industry that government makes which could affect prices or trading strategies would have a long lead time (for example at least 2 years) so that parties can confidently trade this far out. After the many changes that are being made currently though we would hope that the market is left alone; the government seeking back stop powers to intervene is not reassuring for the market, it should

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learn from the mistake of what the threat of intervention does and consequently leave it to the market.

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

We are concerned that the capacity mechanism may negatively affect liquidity as it would reduce the incentive to trade further along the curve, diverting generators away from the market to the mechanism instead.

The increasing amount of regulation, obligations and risks on suppliers could potentially be deterring new companies to enter the market. An example is the uncertain nature of costs for schemes such as FiTs, RO, and soon CfDs as there is credit and cash flow risk to contend with. If government were to fix charges this could go some way in assisting smaller players to manage these obligations.

CHAPTER: Two

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

We agree with the intention of the Secure and Promote option, and much prefer it over the Mandatory Auction which we believe would not meet independent suppliers' hedging requirements. More specifically, we support the 'Promote' part of the model as we believe that something similar to the MMM or the alternative trading obligation will have a bigger impact than securing what has already been delivered (effectively just the increased volumes on the near term market which has not improved the overall state of the market much).

We are concerned by the drive to improve bilateral trading terms as this continues to divert trades away from the market and reduces transparency. We believe that agreements offered between participants bilaterally should be visible on the wholesale market to maintain real competition, as then other parties would have price visibility and could even bid. This is not a request for companies to publish what prices they will trade at on their website as the figure changes very often to reflect the market, but a notification at least on what they traded at once the deal had been agreed would be beneficial. Neither Ofgem, nor the Government should be encouraging a proliferation of secret special deals which would not assist real liquidity. Our only problem is the lack of offering on the wholesale market which could worsen if volume was being diverted from the market to other independent suppliers. Also, if prices were more visible it would help build trust in the industry from consumers.

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We support option B if a market maker obligation is implemented. We would still prefer a self-supply restriction as limiting internal trades would increase liquidity; however, a market maker obligation is still welcome as our second preference as at least it provides the market with numbers. It will also assist in producing robust reference prices which is an Ofgem objective (though we have already made the point that this is a symptom of poor liquidity). As liquidity along the curve is the area where there has not been progress we believe that if Ofgem were to intervene at all in the market to improve liquidity then this is where the focus should lie.

We believe that the requirement for the licensee to buy and sell at least 30% of its generation on a day-ahead auction platform is not required as day ahead liquidity was not a concern previously and market forces should work to encourage continued liquidity on day ahead, especially if the CfD reference prices are set to day ahead markets. In addition, this could concentrate liquidity in day ahead and does not help the potential of liquidity to develop along the curve.

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

We find it difficult to fully assess due to the very high-level nature of the structure at the moment. We are aware that there will be an increasing amount of reporting requirements in future and hope that Ofgem design compliance to avoid firms having to duplicate data submission in different formats.

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

Yes. We have always maintained that the Mandatory Auction is not an appropriate option for intervention as what is required is continuous trading. The Secure and Promote model should be cheaper, more flexible, and actually assist meeting the objectives (providing it includes the market maker obligation and downplays bilateral trades).

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?

Credit and collateral- We are aware that credit/collateral is often cited as an issue in the industry but we are wary of the potential forcing of companies to take on greater risks which their risk management functions would not normally allow.

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Products- We agree that there are benefits of including shaped products (by which we mean standard block shapes) within S&P. We would like to point out that peaks are not bespoke. Also, blocks 3, 4, 5, 6 and overnights are standard products on day ahead so it is not unreasonable to require them along the curve.

If a domestic load profile is to be offered (though it would be unreasonable to expect half hourly shape to be traded more than two days out) we feel that business equivalents should also be available such as the standard business shapes which traded in the days of the Pool. We would like to see all the EFA blocks available for coming seasons and months and also a weekday block 5 for coming seasons and months.

Scope- This targeted approach would only need to be decided upon if Ofgem is determined to improve bilateral trades and this really concerns us (see answer to question 4). What happens when a supplier reaches the arbitrary threshold and no longer qualifies for the special treatment? Presumably they would then have to rely on the wholesale market but with on-going bilateral trades they might find that the products they require, which they had previously enjoyed access to, are not available on the wholesale market. Also the mooted 1TWh threshold is an arbitrary figure which does not bear any resemblance to the different size of the markets suppliers operate in and the power the large vertically integrated companies hold. It would seem more logical to us if a threshold is based percentage of market volume. However, we do not want this suggestion in any way to be used as support for secret trades.

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?

As we have already explained, we are not concerned by day ahead liquidity as the problems of liquidity are caused by parties who own their own generation and who have internal transfers. This is not a day ahead issue because the internal transfers are deals which are usually annual and hence take liquidity away from the forward market where it is lacking.

CHAPTER: Four

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

We originally expected trading to develop along the curve naturally and quite quickly from the near-term market but this has not materialised. We thought that the large vertically integrated companies would start trading on the day ahead markets then realise that they would rather trade along the curve to spread risk. Too much emphasis is being placed on the near-term market and restricting a

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percentage of large vertically integrated companies trade to day ahead will reduce the prospect of trading developing along the curve. Lack of progress in this area is evidence for the need for a market making obligation as Ofgem propose.

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

As we have already pointed out, robust reference prices should not be the aim. If we are to read this question as concern for liquidity along the curve then yes Ofgem should intervene with a market maker obligation as stated in above answer.

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?

The alternative approach does not need to be an actual alternative. It would work without the market maker obligation and vice versa but not as effectively. We identify that there is a risk that the market maker obligation may not result in actual trades as the bid offer spread could potentially be too wide. An obligation to trade will encourage tighter markets and therefore avoids the difficulty of trying to regulate bid-offer spreads which would be required in its absence.

We would like to clarify our stance on platforms. We fully support the alternative approach if it is OTC or a widely available platform so that anyone with access to the market would be able to trade; both the alternative approach and the MMM are much preferred over the costly MA and both would assist access to products.

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?

We share Ofgem’s concern that regulation of bid-offer spreads could risk distorting the price which is why in our previous answer we suggested combining the mandatory market maker and obligation to trade.

We also agree that market makers profit from trading as previously companies have voluntarily made markets so there are commercial incentives.

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

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We see the difficulty creating a hub, along with some other characteristics, as evidence that the MA should not still be a feasible option for intervention. As one of the parties that this proposal is meant to assist we would prefer the alternatives or no intervention rather than the MA (as it does not provide continuous trading which is required and could prove costly and complex).

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

One of the reasons behind the project to improve liquidity is the belief that it will reduce costs as greater competition should keep down prices. This is countered if the intervention measures are costly as they risk outweighing the benefits.

Should you wish to discuss any aspect of these issues further, please do not hesitate to contact me.

Yours sincerely,

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