Consumer Futures

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Dear Phil

Response to 'Wholesale power market liquidity: final proposals for a "Secure and Promote" licence condition'

Thank you for providing us with the opportunity to provide further feedback on the development of this policy. Our submission is entirely non-confidential and may be published on your website.

We provide answers to the questions posed in the annex to this document. If you would like to discuss any point in further detail please get in contact.

Yours,

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Annex: answers to consultation questions

Question 1: Do you agree with our updated assessment of the wholesale market (set out in chapter one and appendix two)?

Yes, we do. We lack the resources to externally validate the data shown in the appendix, but both the data and your commentary on it is consistent with the anecdotal feedback we receive from market participants.

Our conversations with smaller suppliers suggest that most consider the spot/prompt market to be adequate for their purposes but that once you go more than a couple of seasons out the market becomes illiquid and thinly traded, causing them difficulties in hedging their positions. Credit is also cited as a major problem, though we acknowledge that there is a trade-off to be made here and that the large vertically integrated companies have some legitimate anxieties about needing to cover their risk.

DECC's separate work on the difficulties that independent generators are having in reaching Power Purchase Agreements (PPAs), including potentially introducing a form of backstop PPA through the Electricity Market Reform Bill, highlights that independent generators are having difficulties in achieving posted market prices. Heavy discounts would appear to be prima facie evidence of a forward market liquidity problem.

Question 2: Do you agree with our conclusion that we should intervene in the market in the form of the 'Secure and Promote' licence condition?

Yes, we do.

We recognise that market participants are not a homogenous mass and that their needs will vary both between different classes of participant but also within those classes. This lack of common ground has meant, and we suspect will continue to mean, that a consensual solution that pleases all is unachievable. However, the absence of consensus is not an adequate justification for a failure to act when there is clear evidence of a need to do so, and you present a convincing picture that such a need exists.

Ofgem has been acting to tackle liquidity 'urgently' – its word – since 2008 and acknowledged that declining liquidity was a problem as far back as 2005. Significant progress has been made on improving spot market liquidity; this is highly welcome. But in forward markets, there is little evidence of any improvement. As Annex 2 highlights, churn in 2013 is comparable to churn in 2008 and forward spreads remain stubbornly wide – particularly for peak products, where if anything the situation is deteriorating.

We recognise that there are natural attractions to a regulator in seeking voluntary solutions to regulatory problems: the development of approaches that 'go with the grain' of the market; reduced risk of unintended consequences and so on. But, after five years of intensive work, we feel it is clear that a voluntary solution will not happen. While in one part of the consultation you caution against 'unknown unknowns' as being an argument for not introducing measures on short term liquidity, we think one must also recognise that ‘known knowns’ demonstrate a need to act on forward liquidity. It is a ‘known known’ that the situation will not improve voluntarily – even if you lean on the major players for several years. We know this because that approach has been tried – and it has not worked.

The need to implement reform is becoming particularly pressing because of the need to act to secure power supplies in the coming years, and to mitigate the cost of electricity market reform.

Ofgem has repeatedly highlighted its concerns that capacity margins will become tighter, particularly during the middle part of this decade. We agree with you that robust market prices should generate sharper signals on the need for investment in new plant and on when to carry out maintenance. An ability to access market prices without heavy discounts should also affect mothballing decisions and reduce the cost of capital associated with bringing forward new projects.

From 2014, new low carbon plants will initially have the choice of either the Renewable Obligation (RO) or Feed-in Tariffs based on Contracts for Difference (CfD FITs) as a support mechanism, before moving to a CfD FIT only regime from 2017. While there are considerable differences between the two mechanisms, an area of commonality is that for both the support mechanism essentially provides a top-up over a nominal market price (whether forecast (RO) or market reference (CfD FIT)) – rather than the price the generator actually sells its output at. If generators cannot achieve the nominal market price they will not achieve the implied revenue that the support mechanism was intended to deliver. This may mean that either generation does not get built despite the support mechanism (because combined revenues are too low) or that there is inflationary pressure on the strike price (because generators and/or Government pursues higher strike prices to counteract the discount independent generators are seeing on the market price). Neither of these outcomes would be in consumers’ interest.

DECC has set out an expectation that the reference price for CfD FITs will be based on a spot price for intermittent generation and a forward price for baseload generation. The latter is more problematic given that the forward market is far less liquid. We would be concerned if the market reference price was founded on a thinly traded product as this would raise potential problems with market manipulation and with the reliability of this price. The need for CfD generators to achieve the market reference price should drive volumes in those products and it will be important to ensure that whatever liquidity solution you adopt allows trading in that reference product.

Question 3: Do you agree with our proposed legal approach to S&P?

We do not have an in-house legal team, so can only provide comments from a lay perspective.

On face value, the approach adopted appears largely reasonable. In particular, it seems like an improvement on previous proposals that the detailed obligations of S&P would now be included in schedules to the licence condition in order to ensure that any future modifications would follow the standard statutory process. Given the potential materiality, this seems appropriate and should mitigate future judicial review, and regulatory, risk.

There are several references in the consultation that suggest that if the industry could come forward with an alternative delivery mechanism (such as an industry tender) for market making that you might not need a market making licence condition (eg paragraph 4.25). We question whether the tender approach is actually an alternative to having a licence condition (which the consultation seems to imply), or if it is simply one way of discharging that licence condition (i.e. can the licence drafting allow this function to be outsourced?). We would have strong preferences for retaining licence backing even if the tender process is adopted, given our concerns that a voluntary approach has not worked to this point.

Question 4: Do you agree with our proposals for who should face the obligations under S&P?

Yes. It is proportionate to target these obligations only on the largest players; there would be little incremental benefit, but potentially significant cost, in also applying them to small suppliers or the majority of independent generators. We think you make a reasonable distinction for having narrower obligations on Drax and GDF when compared to the Big 6 as while they share some similarities in terms of scale, they are very different in terms of their absence of (material) vertical integration in the power market.

Question 5: Do you have any views on our final proposals for the Supplier Market Access rules, particularly those aspects listed under 'key outstanding design questions'?

We have some concerns that there is a risk of gaming around the edges of the Supplier Market Access rules, though there may not be a perfect solution to this problem.

This concern is driven by the presence of discretion in areas of the rules, combined with the obvious reluctance of some of the affected licensees to be subject to such rules in the first place. We think this creates a risk that an obligated licensee might adopt an approach of doing the bare minimum to comply with those aspects of the licence condition that are 'black-and-white' (such as those relating to the timescales for taking steps) and adopting a 'worst-in-class' approach in those areas where it has discretion (for example, applying materially higher trading fees or more onerous credit terms than other affected licensees). This could have the effect of allowing it to be licence-compliant, but deterring smaller parties from trading with it by making it more attractive for them to trade with one of the other affected licensees. This could create competitive distortions in compliance costs.

We recognise that the only way to fully avoid this would be to be entirely prescriptive on terms of trade, and that to do so may cause more harm than good; suppressing innovation etc. But we think that partial mitigation may be achievable by ensuring total transparency on who is trading and is who is not – in effect, by naming and faming the good and naming and shaming the bad. In chapter 3, you set out quarterly and annual reporting requirements but it is not clear whether some or all aspects of these reports will be made publicly available, or whether they will simply be provided to Ofgem on a bilateral, confidential, basis. We encourage you to do all you can to maximise the public visibility of this data.

On those rules relating to the timeliness of carrying out steps, we note that you are faced with a difficult balancing act – too slow and they may frustrate the policy aim of facilitating market access; too fast and they may increase the compliance costs. On balance, we think that you may be erring too far on the slow side. While a straightforward request may result in an offer being made within 15 working days, a less straightforward one that necessitates a face-to-face meeting could take 85 working days to reach that point – with no subsequent deadline for agreement to be reached following that meeting. As previously highlighted, our clear sense is that several of the obligated licensees will be reluctant service providers and there is a risk that a reluctant licensee could drag things out to a point that deters engagement whilst still complying with their licence. 85+ working days is in excess of four calendar months, and this time window could delay market entry of a new supplier if it has no other hedging options.

We suggest that you consider shortening the 'no agreement' window from 60 to 30 working days. 30 days remains a long enough window that it should not escalate the compliance costs of obligated suppliers, i.e. in relation to needing to cover staff absence, in the way that a very short window would - but it could nonetheless materially improve the timeliness of resolving whether an offer to trade will be made. We also recommend that you consider amending the reporting requirements on obligated licensees to include data on the timeline they have taken from inception to completion of trading agreements in that period.

The rules that you propose to prevent there being a 'cliff edge' where an eligible supplier ceases to be eligible appear arbitrary and at risk of being unduly discriminatory. It appears to be the case that you will maintain, and annually revise, a list of those suppliers that are eligible suppliers and that for as long as a supplier is on that list its dealings with an obligated licensee will be covered by the Supplier Market Access rules. However, this appears to mean that if two suppliers exceeded the eligibility threshold during that year, but one did so right at the start of the year and the other did so right at the end of the year, that both would cease to be eligible on the same day when the next year's eligibility list was published – resulting in differential notice periods in relation to the same event. Arguably this simply replaces an abrupt immediate cliff edge that treats all eligible suppliers the same with a delayed "concertina" cliff edge that treats all eligible suppliers differently. We think this proposal needs further work.

Your proposal (para 3.18) that the rules may need to allow for the offsetting of collateral posted by small suppliers against their payment for energy delivered is extremely welcome and should be developed further. Credit is clearly already a major issue for small suppliers and with the introduction of further credit requirements in relation to the capacity mechanism and CfD FITs, and the likely heightening of existing credit arrangements if we move to fully marginal cash-out as a result of the Electricity

Balancing Significant Code Review, it is vital that you do what you can to avoid such arrangements forming a major barrier to market entry and expansion.

Question 6: Are there any further areas that these rules should cover?

Not at this time.

Question 7: Do you have any comments on our proposed detailed design for the market making obligation, particularly those listed under 'key outstanding designs'?

We welcome the proposal to introduce a market making obligation and consider that this would provide a proportionate remedy to tackle the problem of illiquidity in the forward market.

Regarding obligation B7, 'Trade size', we do not find the consultation clear on how long must elapse before the same purchaser can attempt a similar trade with the same obligated licensee. To use an example, lets say small supplier X wishes to purchase 20MW of a product and obligated licensee Y is offering the best price but is only mandated to sell up to 10MW and only wishes to sell up to 10MW. Can supplier X purchase 10MW from licensee Y and then immediately return and buy a further 10MW from it? If it can only purchase the first 10MW from licensee Y is there a 'lock-out' window before supplier X can return to purchase from it again? If so, what is the lock-out window?

Question 8: Do the detailed elements of the proposed market making obligation appropriately balance costs and risk for the licensees?

There is a risk that in only inviting feedback on the cost/benefit analysis as it applies to obligated licensees that you may leave yourself with an evidence base that suggests the justification for this policy is weaker than it actually is. It would be useful to also draw out the costs and benefits to other market participants.

We note that your impact assessment does not attempt to quantify the benefits of your proposals around market making, only their costs. We share your confidence that the benefits will be significant and think there may be more you can do to illustrate this. For example, you have produced statistical analysis on current bid/offer spreads and churn rates alongside your proposals for mandated narrower bid/offer spreads. The bid/offer spread is a form of implied transaction cost – a cost of churn if you like – and you could estimate the reduction in the costs that would result from the narrower spread that you envisage versus that which exists now.

There is also a reasonable case that can be made that PPA discounts against the market price would narrow and the risk of generation investment would decrease if there was more confidence that forward market prices were robust and that independent generators could realistically achieve this. De-risking independent investment should reduce the cost of capital that ultimately flows through to consumers.

Question 9: Do you believe that an industry-run tender process could more successfully deliver our proposals for a market maker? If so, do you have views on how we can solve the practical challenges we have identified?

We see no reason in principle why an industry-run tender process could not work and it is possible that outsourcing this service could reduce total costs. However we are anxious that the tender route could become a route to delay or dilute reform.

As highlighted in our answer to Question 3, we see tendering for a third party to act as a market maker as one way that a licensee could seek to discharge its licence obligations – and not as an alternative to it having licence obligations. We would be worried if the industry-run tender process allowed the large players to escape licence obligations given that they have a long track record of failing to tackle the problem voluntarily.

Likewise, we would strongly oppose the tender process if it resulted in slippage of the timetable for having market making in place. There is no reason why this approach could not have happened voluntarily in the last five years - if the large players had a genuine desire to see it happen. Requests for more time should not be humoured.

Question 10: Do you agree with our analysis of the costs, risks and benefits of intervening in the near-term market?

Yes – though we would like to see continued monitoring of the near-term market alongside those parts of the market where you are proposing intervention. Please see our answer to question 11 for further details.

Question 11: Do you agree that we should not intervene in near-term markets at this stage?

On balance, yes. Your analysis suggests that near-term liquidity is adequate to meet the needs of most market participants and this view appears to be backed by most independent players.

While this is the case, we note that much of this improvement has coincided with the work you have conducted on liquidity and could, we think, reasonably be construed as a response to regulatory pressure. While we think you make a decent case for believing that progress to date may be reinforced by outside factors such as market pooling and the choice of CfD reference product, this ‘lock-in’ is plausible - not guaranteed. Given that regulatory pressure seems to have been the principal driver of progress to date in this area, we would like to see some reassurance that this pressure will remain in the absence of formal intervention; and after Ofgem's formal liquidity project has been closed down.

So our support for deferring action on near-term markets is contingent on Ofgem providing confidence that it will continue to actively monitor and report on the health of near-term markets alongside those areas where it is intervening.