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Strategic energy market intelligence

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Dear Phil,

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

Cornwall Energy welcomes the opportunity to respond to this consultation.

After more than four years of investigation and negotiation, it is disappointing that the established electricity industry players have been unable or unwilling to put in place arrangements to improve adequately the health of the wholesale power market. Ofgem could not have been clearer that it would have preferred a market based solution opposed to regulatory intervention. Indeed since problems were first quantified by the regulator in 2008 conditions in both the domestic retail and wholesale electricity markets have declined, with consumers now switching far less often and independent players still struggling to pose a credible and sustainable threat to established players.

We see two main factors contributing to the lack of trading in wholesale power markets in GB. Firstly the dual imbalance arrangements at the core of the market design have resulted in the market structure we see today, which is to say that once large players began to consolidate generation and retail into vertically integrated entities to mitigate hedging and imbalance risk trading activity naturally fell away. This sensible commercial response (from a company perspective) to the market design is reinforcing—if you can't beat them, join 'em. As a consequence trading activity has reduced significantly compared to the pre-consolidation early years of NETA. Independent suppliers have fewer counterparties to trade with, particularly for products further along the curve. This in turn seriously impinges the ability of smaller suppliers to grow market share and access output from GB plant. Moreover the vertically integrated companies have reduced incentives to trade outside of their corporate structure as any individual company breaking from the pack will expose itself to unacceptable risk that its larger competitors would not face (hence the "coordinated effect" phenomenon).

We believe the draft policy position on electricity balancing significant code review (EBSCR) and the proposed decision to move to a single cash-out price will have an important effect in this context. Furthermore in the absence of concerted efforts to address this problem we believe the supplier access

rules will be an important enhancement on the current arrangements. Given timescales of the EBSCR, we believe these require very early implementation.

The second issue is credit. The industry is very heavily collateralised; for network charges, imbalance costs, and trading. In sum these credit calls place a large burden on independent players that do not have investment credit ratings and so have to tie up significant amounts of working capital in collateral, rather than growing their business.

This is an important area of weakness in the current proposals and we believe it needs to be addressed. We believe it necessary for parties obligated by S&P to publish how they assess credit. Transparency would allow parties (and potential new entrants) to know requirements from the outset, rather than have to enter into negotiations only to find out some time later that a counterparty insists on credit parameters they cannot meet or afford.

Publication of credit methodologies would allow parties to ascertain the likelihood of how far along the curve they could seek products, their volumes, and which counterparties offer more favourable terms. Greater transparency would also allow benchmarks to appear and reduce the risk of Ofgem having to intervene when parties disagree over whether credit terms are fair.

More generally, given the scale and longevity of credit issues within the industry and its impact on competitive activity, we believe that Ofgem should urgently consider undertaking an SCR into this difficult issue, with a view to optimising levels of credit required under different trading structures and codes. The need to do this is reinforced by new collateral requirements that will arise from EBSCR and under the CfD FiT regime.

Irrespective of whether Ofgem pushes ahead with its S&P proposals, there needs to be regular updates provided to the market on how conditions have improved (or not), a set of success indicators (including timescales over which it expects to see improvements), and the continuation of a regulatory threat of intervention (not just investigation)—what is Plan B?

Our responses to the questions raised in the consultation are given in the attachment. You will see we strongly support the supplier market access requirements. We are less enthusiastic about the market maker proposals as currently framed, and consider the attempt to regulate spreads could have significant unintended consequences and could well prove counter-productive. Under any market maker approach, the minimum clip size needs to be significantly reduced.

Please contact me if you wish to discuss our response further.

Yours sincerely

Nigel Cornwall

Cornwall Energy responses to consultation questions

1. Do you agree with our updated assessment of the wholesale market?

We agree that liquidity—especially further along the curve—remains an issue for smaller suppliers and potential new entrants. Smaller players continue to find it difficult to access the required products necessary for hedging on reasonable terms.

The further tailing off of longer-term peak products is of particular concern as this frustrates smaller supplier's ability to offer a greater variety of longer-term supply deals that some customers prefer and to generally hedge their retail offers on the same basis as integrated companies that can flex generation assets at the point of delivery to match their retail shape and reduce imbalance costs.

2. Do you agree with our conclusion that we should intervene in the market in the form of the "Secure and Promote" licence condition set out in the document?

Intervention of this nature does not come without risks. By Ofgem's own assessment trading activity in longer-term products has not improved despite the regulator consistently identifying problems with the state of the wholesale electricity market since 2008. Although the threat of regulatory intervention has been present for five years, in which time the market was encouraged to come forward with lasting and robust solutions, conditions have not sufficiently improved. There is now compelling evidence that attempts by some of the Big Six to boost liquidity at the day-ahead stage is draining liquidity for products further out.

We acknowledge that some parties have made much publicised efforts to trade with smaller players, but we do not believe that these have not resulted in (nor are likely to in the short term) small suppliers being confident that they can access products they desire on reasonable terms in a timely fashion. There is always the risk that these approaches can be diluted or withdrawn.

Given this we believe that this action has the potential to deliver better outcomes for the wider market relative to previously proposed interventions. Furthermore it is desirable that the implementation of the S&P rules encourages (or at least does not fetter) the participation of financial wholesale market traders too.

For these reasons we actively support the supplier market access rules, though we believe the market maker proposals have now drifted wide of the mark.

The potential pitfalls are highlighted in our response to subsequent questions.

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

Yes. The revised approach seems appropriate but should allow sufficient flexibility to change licence schedules in response to changing market conditions and enable Ofgem to monitor and investigate licensees where necessary.

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

No. The large six vertically integrated companies, which hold in excess of 98% of the domestic market, should be subject to the S&P obligations. As Ofgem concluded in its Retail Market Review the domestic market is stagnating, with the large players exhibiting coordinated effects behaviour. The general consumer perception that there is insufficient differentiation between the majority of providers in the market (in terms of prices and timing of price changes) has reinforced consumer disengagement.

If the market is to permit the competitive fringe to seriously challenge the larger players then obligations to trade should be placed on those companies that hold the majority of capacity and customers. It is inappropriate to include Drax and GDF Suez in the S&P obligations as neither of these entities has a presence in the domestic market. They also have strong incentives to take volumes to market, either via

trading or their affiliated non-domestic supply businesses. Competition in the non-domestic market is significantly healthier than in the household market.

As part of its on-going monitoring of obligated parties and the wider impacts on the market Ofgem should give consideration to how these (and other policy and licence obligations) impact on a market participant's behaviour. The introduction of the S&P licence conditions will further splinter the market in terms of regulatory and policy obligation burdens. In the round as participation in programmes or schemes are defined by market share an assessment of the costs, opportunities and risks must be understood so that, in combination, they do not drive sub-optimal behaviour.

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"?

Broadly speaking the Supplier Market Access (SMA) rules will ensure a standardised approach to the timing and structure of processes for trading. This will reduce costs for all parties (as operational changes should be limited, given what parties have said regarding their current efforts to trade) as negotiations are concluded within a reasonable time. Where a trading arrangement is not put in place the reasons for not executing a deal will be known. It is disappointing that, despite the threat of regulatory intervention being present for a number of years, the Big Six (in isolation or via one of their trade associations) have not put in place similar arrangements.

We do have concerns though that the suggested product range will not be sufficient to enable new entrants and smaller players to access the desired shape necessary to hedge their market exposure risk on a similar basis to companies present on both sides of the market. In addition to the proposed products, mandated parties should also be obliged to offer terms for intra-day, weekend and weekday products (such as those standard products offered on existing platforms) for at least six months forward. We disagree with Ofgem's assertion that these are bespoke products as they are already present in the market.

Neither is the rationale clear for allowing the obligated party to have to respond within three hours to a trade—this should be reduced significantly (e.g. 30 minutes) to ensure commitments can be locked-in rapidly.

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

We believe there are some significant gaps.

As drafted at the moment we see little or no scope for the SMA to encourage innovative approaches to credit, products or contract terms. It is not in the commercial interests of the Big Six companies to go above and beyond the SMA intention to facilitate competitors' ability to grow market share.

As noted in our introductory remarks, the dual imbalance price arrangement at the core of the market encourage vertical integration and place strong incentives on parties to "balance" generation output to demand. This in turn erodes any desire to grow customer bases (unless it is matched with a corresponding change on the generation side).

In the interests of innovation (particularly on approaches to credit), we believe obligated parties should offer market access to financial wholesalers. This in turn would increase churn and would introduce a much needed shot of innovation in the traded market.

Where possible as much information as possible that Ofgem collects during its monitoring activity should be published. This will provide valuable information to smaller parties and prospective new entrants on the effectiveness of the S&P package.

7. Do you have any comments on our proposed detailed design for the market making obligation, particularly those listed under "key outstanding design questions"?

Ofgem's thinking on the market making role seems to have evolved dramatically over the period of the investigation. In some respects its proposals seem to have taken on a number of attributes of the mandatory auctions that the market generally considered a disproportionate intervention.

We are particularly concerned about the mandation of bid-offer spreads, as this may have unintended consequences. For example it could deter large financial wholesale players from entering the market and increasing liquidity as they may not wish to match the spreads on certain products for smaller players that obligated parties are required to provide.

As the market making obligation will be discharged through a platform, close consideration must also be given to the credit requirements placed on parties to use these platforms. The industry is already heavily collateralised, and credit calls are to increase with the introduction of the Electricity Market Reform programme (specifically the supplier obligation for CfD FiTs and the capacity mechanism). It is also likely that the outcome of Ofgem's Electricity Balancing Significant Code Review (if initial proposals are implemented) will further increase credit requirements.

Smaller players (and prospective new entrants) will naturally have lower credit ratings compared to larger parties. While this reflects risk present in the market, the issue of whether current credit arrangements across the piece are reasonable and ultimately benefit the wider market needs to be addressed. Small players will often have no option other than to post cash as collateral thus further tying up working capital. We challenge Ofgem to provide a robust assessment of the impacts all credit calls (trading—including balancing, networks, and government programmes) have on parties ability to grow their businesses and challenge larger players dominance.

We are agnostic to whether parties discharge their obligations via a third-party, provided this does not further delay interventions or load unnecessary cost into the market.

An important point concerns clip sizes. New entrants (and prospective entrants) will need to access products smaller than 5MW. As a result the smallest clip size offered should be at least 0.5MW.

8. Do the detailed elements of the proposed market making obligation appropriately balance costs and risks for the licensees?

Costs incurred establishing the market making obligation should be viewed in the context of wider market benefits (reduced barriers to entry, vigorous retail competition, and trusted reference prices for CfD FiTs) and not just those of licensees. With suitable modification as outlined in response to the previous question, we think these benefits will be considerable.

9. Do you believe that an industry-run tender process could more successfully deliver out proposals for a market maker?

This is doubtful, and it took in excess of four years to establish the N2Ex platform (and longer for it to build scale).

We also doubt whether there would be a great deal of interest from parties best suited to perform this function (due to mandated bid-offer spreads). As mentioned above the mandated parties have no incentive (other than regulatory compliance) within the current market structure to innovate or deliver solutions in a timely and cost efficient manner.

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

We agree that the costs of intervening in the near-term market would outweigh any associated benefits, particularly as liquidity issues are far less significant here than is the case further along the curve. We also agree that Ofgem should continue to monitor the near-term market.

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

Yes, please see our answer above. The issue is essentially one of credit, which is less of an issue at the near end of the curve, meaning that smaller players are better able to fulfil their requirements in the near-term markets.