

**Which?**

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## Consultation Response

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

Which? is the largest consumer organisation in Europe. It is an independent, not-for-profit consumer organisation with almost 800,000 members. Which? is independent of Government and industry, and is funded through the sale of Which? consumer magazines, services and books. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.

As the Which? report *The Imbalance of Power - Wholesale Costs and Retail Prices*<sup>1</sup> sets out, Which? considers the effectiveness of the wholesale electricity markets to be insufficient and that steps must be taken to address this. As a result, Which? welcomes Ofgem's focus on the liquidity of the electricity market. As this response sets out, while we are supportive of the sentiment of the proposals set out in this consultation and a number of the proposals,<sup>2</sup> we consider that the focus and objective of this programme has been too narrow to deliver the level of change that is needed.

Energy is an essential purchase and all consumers should have access to fair and transparent prices in order to play their allocated role and drive competition in the market as well as manage their own costs. Rising energy costs are a top financial concern for consumers, with many people dipping into savings or even going into debt to pay these bills.

The average energy bill is now £1452<sup>3</sup> and of this, 60% - around £852 - is attributed to wholesale energy costs.<sup>4</sup> Increases in wholesale energy costs have been the primary reason cited by suppliers for the general rise in consumers' energy bills.<sup>5</sup> The increase in household

<sup>1</sup> Which?, *The Imbalance of Power - Wholesale Costs and Retail Prices*, July 2013

<sup>2</sup> Ofgem, *Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence consultation*, June 2013

<sup>3</sup> Ofgem, *Electricity and Gas Supply Market Indicators*, July 2013

<sup>4</sup> Ofgem, *Updated household energy bills Explained*, January 2013

<sup>5</sup> E.ON press release, 'E.ON increases prices by 11.4% for electricity and 18.1% for gas as world events force wholesale price rise', 5th August 2011, accessed online at [pressreleases.eon-uk.com/blogs/eonukpressreleases/archive/2011/08/05/1729.aspx](http://pressreleases.eon-uk.com/blogs/eonukpressreleases/archive/2011/08/05/1729.aspx); Raymond Jack, Scottish Power Retail Director, as quoted in the Guardian, June 2011: "Wholesale prices for gas and electricity

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energy bills has been substantial: since 2001 electricity bills have risen by 66% and gas bills by 137%.<sup>6</sup> However, consumers mistrust the claims made by suppliers about why their prices are increasing. Despite suppliers' assertions of very low margins from their retail businesses, 84% of consumers think price rises are due to energy companies increasing their profits, rather than meeting increased wholesale costs, and 64% disagree with the statement that their supplier prioritises customers over profits.<sup>7</sup> The majority of consumers do not trust energy companies,<sup>8</sup> and their main reason they gave for this was that they thought energy companies were greedy and made too much profit.<sup>9</sup> This is not surprising, as announcements of rises in group profits have often swiftly followed the latest round of price increases.

The level of wholesale costs is influenced by a number of factors. This includes for example, the underlying commodity cost, and importantly the effectiveness of competition in the different wholesale markets. Effective competition in the wholesale energy markets, with high levels of liquidity, is essential if the markets are to deliver efficient prices. If the markets are not effectively competitive and suffer from low liquidity, consumers will pay more than they need because it stops new entrants coming into the market and challenging prices and it hampers more effective price competition from incumbent companies.

Ensuring that wholesale energy markets are truly competitive is as important in determining the prices consumers will pay in the future as it is for determining today's retail prices. Significant investment in new electricity generating capacity is urgently required<sup>10</sup> and the wholesale energy markets should play a role in encouraging companies to make that investment.<sup>11</sup> Price information from the wholesale electricity markets should reveal commercial opportunities for prospective or existing generators and give confidence that engaging in the markets will help manage commercial risk. To attract investment from a range of organisations - not just the six large vertically-integrated energy companies - investors must have confidence that the wholesale energy market is competitive, and that

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have increased significantly since the end of the last year and continuing unrest in global energy markets means future prices are volatile", accessed online at [www.guardian.co.uk/money/2011/jun/07/scottish-power-raises-gas-bills-electricity-prices](http://www.guardian.co.uk/money/2011/jun/07/scottish-power-raises-gas-bills-electricity-prices); Ofgem, 'Why are energy prices rising?', October 2011, accessed online at [www.ofgem.gov.uk/](http://www.ofgem.gov.uk/)

[Media/FactSheets/Documents1/Why%20are%20energy%20prices%20rising\\_factsheet\\_108.pdf](http://www.ofgem.gov.uk/Media/FactSheets/Documents1/Why%20are%20energy%20prices%20rising_factsheet_108.pdf); Energy UK website, October 2012:

"Prices that consumers pay are affected by the wholesale price of energy, which is the price companies pay to buy the gas or electricity they sell on to the end user", accessed online at [www.energy-uk.org.uk/publication/finish/3/286.html](http://www.energy-uk.org.uk/publication/finish/3/286.html)

<sup>6</sup> Based on DECC, Chart 2.1.2, Quarterly Energy Prices, June 2013

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/208286/qep\\_june\\_2013.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/208286/qep_june_2013.pdf)

<sup>7</sup> Populus conducted telephone interviews with 2009 GB adults and 201 adults in Northern Ireland between 24 November and 2 December 2012. Data were weighted to be demographically representative of all UK adults. Populus is a member of the British Polling Council and abides by its rules.

<sup>8</sup> Of Populus above, just 28% of consumers trust energy companies to act in their best interests, 56% saying that they do not trust energy companies to provide a fair price.

<sup>9</sup> Of Populus above, 46% Of those who don't trust their gas and electricity companies to act in their customers best interests, the top most common responses was 'greedy / too much profit' (46%)

<sup>10</sup> DECC estimate that £110 billion of investment is needed to replace current generating capacity and upgrade the grid by 2020, and to cope with a rising demand for electricity,

[www.decc.gov.uk/en/content/cms/legislation/energybill2012/energybill2012.aspx](http://www.decc.gov.uk/en/content/cms/legislation/energybill2012/energybill2012.aspx)

<sup>11</sup> Ofgem, Liquidity Proposals for the GB wholesale electricity market, February 2010; DECC Energy Bill Series

[www.gov.uk/government/organisations/department-of-energy-climate-change/series/energybill](http://www.gov.uk/government/organisations/department-of-energy-climate-change/series/energybill); DECC: "We need to reform the UK [wholesale] electricity market to attract the investment needed to replace our ageing energy infrastructure and meet the projected future increases in electricity demand...", accessed online at [www.gov.uk/government/policies/maintaining-uk-energy-security--2/supporting-pages/electricitymarketreform](http://www.gov.uk/government/policies/maintaining-uk-energy-security--2/supporting-pages/electricitymarketreform)

they have a fair chance of generating a return.<sup>12</sup> Robust wholesale electricity price information will also be central to ensuring that consumers get a fair deal from the Government's Electricity Market Reform (EMR),<sup>13</sup> which is designed to bring on future investment. However the current arrangements fail to do this: they neither give consumers confidence in prices they are paying today nor investors the confidence to invest for the future.<sup>14</sup>

## Questions

### **Question 1: Do you agree with our updated assessment of the wholesale market?**

#### Yes, low levels of liquidity remain in the and needs to be addressed

The low level of liquidity in the wholesale electricity market is well recognised (set out below) and is undesirable. It hampers the entry and growth of independent companies and limits competition between incumbents. It raises serious questions about the ability of the market to keep prices efficient, as well as the viability of using price data from these markets to set or index prices paid by energy suppliers, including those of the six major suppliers. And in markets with low levels of liquidity it is easier for the prices to be manipulated with a single or small number of trades.

#### Low liquidity is well recognised and persists despite improvements in the day-ahead markets

Low liquidity of the GB wholesale electricity market is well recognised. There is little doubt that the GB wholesale electricity markets suffer from low liquidity.<sup>15</sup> GB has low churn ratios compared to other European markets, with particularly low traded volumes for products bought further out<sup>16</sup> and increasingly wide bid-offer spreads for products 12 months out.<sup>17</sup>

The establishment of N2EX in 2010 began to improve the liquidity (and transparency) in the day-ahead market, and traded volumes have risen from 18.7TWh in 2011 to 94.8TWh in 2012<sup>18</sup> and across N2EX between 2.5 and 3TWh of electricity is traded a week.<sup>19</sup> The increased

<sup>12</sup> Low margins in retail and generation - particular the low spark spread (margins from gas powered electricity plants) have been speculated to be limiting the interest of new entrants

<sup>13</sup> The Electricity Market Reform (EMR) is the Government's primary policy programme to bring on investment in low carbon generating capacity. There are four pillars to the programme: Feed in Tariffs with a Contract for Difference; Carbon Price Support; Capacity Mechanism and Emissions Performance Standard. The EMR is discussed in detail in our accompanying report Which?, The Imbalance of Power: The Challenge of Decarbonisation, July 2013

<sup>14</sup> [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/197633/liquidity\\_measures\\_ia.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/197633/liquidity_measures_ia.pdf)

<sup>15</sup> DECC, Energy Bill 2012 Impact Assessment: reducing barriers to securing long-term contracts for independent electricity generation investment, August 2012; Ofgem, Retail Market Review: Intervention to enhance liquidity in the GB power market, February 2012: "Following our Retail Market Review (RMR) in March 2011, we found that consumers were at risk from low wholesale power market liquidity, which was potentially acting as a barrier to entry and reducing the effectiveness of competition." DECC and HMT Energy Market Assessment, March 2010.

<sup>16</sup> Low churn ratios compared to other European market. In 2009 the British market had a churn ratio of 3. By comparison, the Nordic market had a churn level of 7 and the German market estimated to have a level of 8. There are low traded volumes for products bought further out (along the time curve), particularly peak products (electricity volumes bought for delivery during peak consumption hours). Ofgem, Liquidity in the GB wholesale energy markets, June 2009, figures 2.4a and b.

<sup>17</sup> Ofgem stated they saw a widening of the bid-offer spread in July 2012 (source: Retail Market Review: GB Wholesale market liquidity update, Ofgem, July 2012), this remained the case in December 2012 (source: Wholesale power market liquidity: consultation on a 'Secure and Promote' licence condition, Ofgem, December 2012)

<sup>18</sup> Ofgem, Wholesale power market liquidity: final proposals for a "Secure and Promote" licence condition, June 2013, Appendix 3

<sup>19</sup> N2EX data reports

volumes traded on N2EX<sup>20</sup> have been supported by commitments from a number of the large vertically-integrated energy companies to trade through this exchange. They have now set up gross bidding agreements to do this. While the six large vertically-integrated companies have announced their commitment to this day-ahead market, the gross bidding agreements between them and N2EX do not drive as much competition as they could. These gross bidding agreements with N2EX are based on balanced bids - where the supply and generation divisions put in bids that have equal amounts of power to be sold and bought, rather than the divisions putting in completely separate bids, with no disclosure of volumes or prices between the divisions. However, in Nordpool the primary electricity market used in Scandinavia (an operator of N2EX), there has been a move to using gross bidding agreements that commit to submitting separate bids in order to increase transparency and robustness in this market.<sup>21</sup>

Beyond this shift in the day-ahead market, the aggregate levels of churn in the electricity markets started to fall in 2010 and are continuing to do so - as this consultation set out levels are marginally lower in 2013 than during the same period in 2012.<sup>22</sup> This suggests that there has not been an increase in overall traded volumes, but rather that this increased activity in the day-ahead market has been pulled from another market. Following a continued widening of the bid-offer spreads,<sup>23</sup> particularly for products further out, there has been a narrowing since the start of 2013. However it is not clear whether this will be sustained. Ofgem itself stated that the narrowing may be because traded volumes tend to be higher in the first quarter of the year.<sup>24</sup>

### The wholesale electricity markets are not as open as they should be

As Ofgem note in this consultation, the wholesale markets do not function equally well for all participants, with both independent suppliers and generators often struggling.

#### *Independent suppliers*

Independent suppliers face various problems in the retail<sup>25</sup> <sup>26</sup> and wholesale markets.<sup>27</sup> In the wholesale energy markets their lack of credit and collateral, or free cash to back collateral requirements, is often cited as impeding their ability to access a range of platforms to source the energy supplies they need. For example, they may have to focus or pool all their resources for the OTC market and they may not have the resources also to trade on exchanges.

Finding energy products that are of the right size (generally small), with the right profile is also an issue. Some suppliers have struggled to get a response from the large vertically-

<sup>20</sup> In 2012 an equivalent of 97TWh were traded on the auction, a significant increase from the 18.7TWh in 2011.

<sup>21</sup> [www.statkraft.com/presscentre/news/statkraft-enters-grossbiddingagreement-with-nordpool-causing-higher-spot-volumes.aspx](http://www.statkraft.com/presscentre/news/statkraft-enters-grossbiddingagreement-with-nordpool-causing-higher-spot-volumes.aspx)

<sup>22</sup> Ofgem, Retail Market Review: GB Wholesale market liquidity update, July 2012. Ofgem, Wholesale power market liquidity: proposals for a 'Secure and Promote' licence condition, June 2013, Figure 1.

<sup>23</sup> Ofgem, Wholesale power market liquidity: consultation on a 'Secure and Promote' licence condition, December 2012.

<sup>24</sup> Ofgem, Wholesale power market liquidity: proposals for a 'Secure and Promote' licence condition, June 2013, Appendix 3

<sup>25</sup> Institute for Public Policy Research, The True Cost of Energy, April 2012.

<sup>26</sup> As the Which? report The Imbalance of Power: The Retail Market published in December 2012 set out this also help contribute to the illusion of competition while keeping the majority of the market segmented away from the best prices.

<sup>27</sup> Energy Suppliers Forum, "Maintaining a healthy competitive fringe" - Addressing issues facing independent electricity suppliers, June 2008, accessed online at

[www.esnet.org.uk/cms/data/files/small%20suppliers%2018%20June%202008/Issues%20facing%20independent%20energy%20suppliers%20paper%20for%20circulation](http://www.esnet.org.uk/cms/data/files/small%20suppliers%2018%20June%202008/Issues%20facing%20independent%20energy%20suppliers%20paper%20for%20circulation).



integrated companies if they approach them to buy energy, and if they do get a response it may not be on terms considered reasonable.

#### *Independent generators*

There are a range of issues facing independent generators. The change in relative cost of gas and coal and the impact that this has on margins, the introduction of the new carbon tax and the uncertainty created by the introduction of the wider EMR programme are issues facing all generators, including the independents. Specific issues for independents are the continued lack of liquidity and the challenges in securing bankable Power Purchase Agreements at reasonable prices and fit with the generators' interests.

**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 set out in this document?**

Which? agrees that action is needed and supports the sentiment of Ofgem's proposals but we do not support the market maker proposal

Which? agrees that action needs to be taken to improve the effectiveness of competition in the wholesale electricity markets. The current situation is failing to deliver efficient prices for consumers and is not acceptable.

Which? broadly supports the sentiment of Ofgem's direction of travel with the 'Secure and Promote' package and we recognise that the proposals reflect Ofgem's jurisdiction over licenced suppliers and generators. As set out below we support a number of aspects of the 'Secure and Promote' package but we also have a number of concerns, most significantly with the market maker obligation: we consider the proposal risks further entrenching the presence and role of the large vertically integrated energy companies in the GB markets.

#### *Supplier Market Access Rule*

Which? supports the introduction of the Supplier Market Access Rule. Reasonable terms should support the entry and growth of a range of suppliers. However, as set out above it is not solely independent suppliers who struggle, the independent generators also often find the wholesale electricity markets challenging.

#### *Market Making Obligation*

As the report *The Imbalance of Power - Wholesale Costs and Retail Prices set out*, Which? considers that the introduction of market makers warrants serious consideration. However Which? does not support the Market Making Obligation set out in this consultation.

With this proposal Ofgem is attempting to remedy two issues with a single proposal: the lack of total volumes of electricity available for trading; and low levels of trading of certain products and volumes. While we agree that both issues need to be addressed, and Which? is sympathetic to the idea of a market maker, by placing this obligation on the six large vertically-integrated energy companies, the role of these companies becomes even further embedded in the GB energy markets.

Furthermore, there will be costs to meeting this obligation and, as there will be no change to the underlying company structures, there is no reason to believe there will be any incentive to incur these costs efficiently and so mitigate the impact on customers' bills.



Finally, the bid and offer prices that these companies are to post will not be prices produced as a result of price discovery through trading. As a result it is not clear what the incentive will be for these companies to offer efficient prices.

#### *Reporting requirements*

The final strand - the reporting requirements - are positive as they demonstrate that Ofgem has recognised the need for on-going monitoring and the importance of the near term (day-ahead) markets with the implementation of the EMR. However this strand does not include any proposals to improve the quantity or quality of price information available. As the Which? response to the Ofgem call for evidence on price benchmarks set out, we consider the methodology used by price reporter agencies - the primary source of price benchmark information - to be vulnerable to manipulation and unrepresentative.<sup>28</sup>

Which? considers the focus and objectives of this programme to have been too narrow  
 Ofgem's Secure and Promote proposals may be effective for meeting some of the needs of independent suppliers. However Which? considers that the focus and objectives of this programme have been too narrow. For example it has not considered the impact of the structure and governance of vertically integrated energy companies more widely.

Which? considers that vertical integration has skewed the market, penalised new entrants and impaired competition. Vertically-integrated companies are able to supply themselves with electricity, and this type of self-supply is said to account for a significant share of wholesale electricity sales in the UK. Self-supplying reduces the amount of price information available for others to use as benchmarks or reference prices because the prices that the upstream electricity generation or gas production businesses charge their own supply businesses are not published. It also reduces both the volume of energy available for sale to other suppliers and the amount of energy that suppliers need to buy on the open market from other generators. The combined impact of these factors has raised concerns that the dominant position of the six major energy companies is having a detrimental impact on independent suppliers and generators - by limiting the availability of volumes, buyers and purchase agreements and so restricting the total amount of competitive activity in the market. In conclusion, while this current market structure may be providing consumers with a reliable supply of energy, there is no evidence to suggest that it is also delivering costs that are efficient or fair. Indeed, what evidence is available suggests that the reverse is true.

As a result of a failure to consider the effects of the wider market arrangements on wholesale prices, we fail to see how these proposals will create a balanced and open market and put in place the right incentives needed for effective competition in the wholesale energy markets.

**Which?**  
**August 2013**

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<sup>28</sup> Which? response to *Ofgem a Call for Evidence - Price Benchmarks in the Gas and Electricity Markets*, August 2013