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18<sup>th</sup> December 2013

Dear Graham,

**Wholesale power market liquidity: the 'Secure and Promote' licence condition**

First Utility is the UK's largest independent utilities supplier, offering electricity and gas services to a range of consumer and business customers. With now around 300,000 dual fuel domestic customers, we have gained substantial experience of the issues driving a lack of competition in the energy sector and how these impact UK consumers.

Independent suppliers such as First Utility are greatly disadvantaged at present in relation to the lack of liquidity and robust price discovery in longer term standard and shaped products. In contrast, integrated suppliers are largely protected from this issue through the availability of internal generation output that acts as a natural risk mitigant for these wholesale market issues: a solution not available for those operating outside an integrated utility business model.

To this extent, First Utility does not believe the Secure and Promote proposals are sufficient to drive the step change in liquidity of standard and shaped products the UK wholesale electricity market requires. For the mandatory market obligation (MMO) to drive a meaningful increase in wholesale liquidity we make the following observations:

**1. Vertical Integration is the reason why forward wholesale liquidity is low**

Vertical integration of utilities impacts liquidity in the market place. Depending on how well matched the upstream (generation) and downstream (supply) businesses are, a vertically integrated company has little need to sell products into, or purchase from, the wholesale market as they can sell their generated volumes directly to their supply business. This is why very little product is for sale along the forward curve in the wholesale market.

Consequently, we do not believe the lack of liquidity further along the forward curve is mainly the result of credit concerns, but instead from a reduced need to trade by vertically integrated players in the market. In a liquid market with robust price discovery, it is market intermediaries who normally provide innovation around the warehousing of risks (market price, volume and credit risks) for smaller and new entrant participants both upstream and downstream. The lack of current market intermediary participation is a symptom of the current market structure resulting in a detrimental impact on liquidity.

A successful liquidity intervention must mandate the vertically integrated companies to release more forward products into the wholesale market rather than transferring products internally from generation to supply. We believe the current proposals will allow vertically integrated suppliers to adjust the timing of their normal market activities in order to tag those actions as ‘MMO actions’, with almost zero net increase in liquidity.

We believe that mandated players may curtail trading activity at other times in the market in order to manage a mandated market making obligation. This will lead to the risk that volumes are simply transferred from one pool of liquidity (or time of liquidity) to another, with no net increase in liquidity across the UK wholesale electricity market as a whole. Current levels of trading activity reflect the current lack of need to trade, not a lack of marketplaces to trade.

## **2. Vertical integration adversely impacts forward Peak and “Shaped” product availability**

We note that baseload liquidity is poor more than 2 years forward, but that liquidity deteriorates far more rapidly for peakload products. Products that are more ‘shaped’ than peakload (for example 4 hourly ‘blocks’ and products that match the Non Half Hourly intra-day and monthly profiles of domestic customers) are not openly forward traded on the wholesale market, despite these products being exactly the requirements of domestic suppliers. A key characteristic of a liquid market is that it is ‘complete’ – meaning that there are a ‘complete set of products’ for sale that allow all market participant types to forward hedge their natural businesses. The UK wholesale electricity forward market is very far from complete.

The vertically integrated suppliers own the flexible generation units that can produce these shaped products. It is the punitive dual-priced cashout mechanism that creates the economic incentive for such participants to hold this flexible (or shaped) product until delivery as an imbalance cost mitigant in their own vertically integrated portfolio. The lack of sales of forward shaped products is extremely detrimental to competition as these are the very products supply companies must purchase to hedge their customer base. This is clearly a big barrier to the growth of the independent suppliers who are needed to drive retail competition. Whilst measures under the Electricity Balancing Significant Code Review may in part reduce such economic signals, they will be far from sufficient.

We do not agree with the suggestion that greater liquidity in the near term market will necessarily translate to an equivalent degree of liquidity at the far end of the curve. The market intermediaries who might trade the forward market do not do so in order to take a position to delivery, they do so mainly with the intention of ‘closing out’ their forward position at opportune moments far ahead of delivery. ‘Value at Risk’ (VaR) limits and credit limits would restrict the ability to hold significant forward positions all the way to delivery.

A successful liquidity intervention should increase the range of products sold in the forward market, particularly shaped products.

The intervention must mandate the vertically integrated companies to release shaped products into the forward market. We believe that the intervention must mandate the sale of the following shaped products:

- Peakload, with monthly granularity in the first 24 months forward
- Weekday and Weekend 4 hourly 'Block' products, with monthly granularity in the first 12 months forward

By mandating the market making of shaped products by the vertically integrated companies, a more complete set of forward products will be available in the market, allowing current and potential new suppliers to gain confidence in ability to hedge. This would also allow potential new generation entrants to gain confidence in more accurately valuing flexible generation as part of their investment decisions, so it is good for the wider market also.

### **3. Time, volume and reloading limits will erode the value of the market making obligation.**

The proposals currently envisage 'time windows' of trading mandation, with caps on mandated volumes and relaxed 'reloading' provisions. This combination of proposals significantly erodes the level of mandation on the vertically integrated companies. We believe that the combination of (i) a limited mandated product list, (ii) a limited mandated volume and time window acts to make the impact of the MMO very low indeed. We believe that liquidity needs to double and the product list needs to widen. We believe that the rules on volumes and times are likely to make the MMO insignificant as a driver of liquidity.

An MMO will not drive a meaningful increase in forward trading unless it is mandatory for a far higher percentage of the time than proposed by Ofgem. Bid-offer spreads 'not excessively wider than the market' do not drive bid-offer spreads narrower, but could instead lead to the opposite: mandated players may chase the other mandatory bids and offers ever wider, which would be allowed under Ofgem's proposals.

### **4. Lack of liquidity as a threat to Electricity Market Reform.**

Should narrow 'time windows' of trading mandation be used to set CfD FiT reference prices, this would introduce significant gaming risk into the settlement prices of the CFD FITs. This in turn would push up the cost of the CFD FIT regime for consumers. For this reason, lack of market liquidity is the most significant risk to the success of EMR. To put the size of risk into context, the total Supplier Obligation cost in 2016 according to DECC would be around £234m rising to £2,549m in 2020. Cornwall Energy's analysis however suggests an even greater level rising from £508m in 2016 to £3,071m in 2020. Consequently under current proposals, with settlement based against an illiquid market index, the cost impacts on consumer bills could rise substantially higher.

**Conclusion:**

Considering the above points, we believe that the best and simplest solution to promote liquidity would be a Self-Supply Restriction (SSR) on the incumbent vertically integrated participants. Such a solution focuses not on the specific detailed trading activities such participants must undertake, but it instead describes the one activity that those participants cannot undertake: internal energy transfers. This leaves the integrated utilities free to sell their generation output when they like, to whom they like, under credit and price terms they commercially agree with third parties. This does not artificially force liquidity, but instead ensures trading is based on supply and demand fundamentals along the forward curve.

Requiring integrated utilities to sell all of their generation output into the forward traded market will immediately drive a need for their supply businesses to source shaped products from the market to hedge their retail portfolios too. The resulting price discovery on generation output and retail shape would lead also to product discovery and a rapid and beneficial step change in liquidity. An SSR could be easily monitored by restricting the movement of power from those companies' production to consumption accounts.

Finally, we note that Elexon would hold data on the level of any ECVN and MVRN activity between the consumption and production settlement accounts of integrated participants, which would be helpful data enabling Ofgem to form an accurate picture of the historic evolution of the level of internal volume transfers in such utilities. We believe this would likely be a very useful indicator as to the reasons for low levels of liquidity in the UK wholesale electricity market and would provide another view to compare against claims by some incumbent utilities that they already dispatch 100% of their generation portfolio into the wholesale market.

Please do not hesitate to contact myself ([jonathan.smith@first-utility.com](mailto:jonathan.smith@first-utility.com)) or my colleague Emma Piercy ([emma.piercy@first-utility.com](mailto:emma.piercy@first-utility.com)) should you have any questions or require any further information.

Yours sincerely,

Jonathan Smith

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