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Consultation Response

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Pricing benchmarks in gas and electricity markets - a call for evidence

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Which? welcomes Ofgem's consideration of whether the price benchmarks in the wholesale energy markets are fit for purpose.¹ As the Which? report *The Imbalance of Power - Wholesale Costs and Retail Prices*² sets out, Which? considers the quality and quantity of wholesale price information currently available insufficient.

Energy is an essential purchase and all consumers should have access to fair and transparent prices. 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 £1452³ and of this, 60% - around £852 - is attributed to wholesale energy costs.⁴ The level of wholesale costs is influenced by a number of factors such as the underlying commodity cost and the effectiveness of competition in the different wholesale markets. Playing an important role in this is the wholesale price information and, in the current arrangements, price benchmarks developed by Price Reporting Agencies (PRAs) are a primary source of this.

Wholesale price information can be used for setting contract terms, to inform bids and offers for volumes of energy and to set or inform transfer prices. Wholesale price information can be used by prospective investors. And with the introduction of Contracts for Difference, as part of the Electricity Market Reform, wholesale electricity price information will be central to

¹ Ofgem, *Price benchmarks in gas and electricity markets - a call for evidence*, June 2013

² Which?, *The Imbalance of Power - Wholesale Costs and Retail Prices*, July 2013

³ Ofgem, *Electricity and Gas Supply Market Indicators*, July 2013

⁴ Ofgem, *Updated household energy bills Explained*, January 2013

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ensuring that consumers get a fair deal. Wholesale price information will form the basis of reference prices that will be used to determine the level of subsidy that consumers will pay, as well as being used to inform the initial strike prices.

It is therefore crucial that all stakeholders have confidence in wholesale price data and as the majority of trading is over the counter (OTC), this confidence must extend to the PRAs and the benchmarks they produce.

The quality of information currently available needs to be improved

There are three factors impacting on the quality of wholesale price data:

- First, there is a lack of formal and robust data gathering. As a result the process for gathering information is vulnerable to manipulation.
- Second, the level of competition in either the gas or electricity wholesale markets isn't sufficient to give confidence that the data reflects efficient and competitive prices.
- Finally, the volumes of gas and electricity actually traded openly appear to be small, representing a small proportion of the volumes being consumed.⁵

A process vulnerable to manipulation

Which? believes the process for data collection by the PRAs is vulnerable to manipulation. As Ofgem describes in this request for evidence,⁶ PRAs get their data by surveying market participants rather than directly from data. Traders are a key source of information and may provide information from a range of sources. For example, it may include trades that they have undertaken, trades they know of, as well as the range of bids and offers available in the market.

There are strong parallels with the Libor scandal. As the Wheatley review of Libor said, 'submissions were reliant on judgement, rather than transaction data'. As in the Libor assessment of bank lending rates, the administrative mechanism in energy price reporting provides opportunity for contributors to attempt to manipulate submissions, as submissions are not always based on transactions and the process is self-policing.

The dubious effectiveness and representativeness of trading in the wholesale energy markets

To be confident that the underlying prices are efficient, competition must be working effectively. As Ofgem's own analysis has shown, the level of liquidity in the wholesale electricity market is limited and over recent years it has continued to decline.⁷ While the British gas markets are considered to be very liquid, there are on-going investigations into allegations of manipulation.⁸ This raises questions of the robustness and quality of the data gleaned from these markets.

Furthermore, the volumes of energy that are actually traded raise a further challenge to the reliability of wholesale energy price data or at least how representative the data from OTC and exchanges are. The majority of energy trading is uncleared OTC. But as a result of the

⁵ For further detail see Which?, *The Imbalance of Power - Wholesale Costs and Retail Prices*, July 2013, Chapter 4.

⁶ Paragraphs 2.15 and 2.17, Ofgem, *Price benchmarks in gas and electricity markets - a call for evidence*, June 2013

⁷ 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; Ofgem, *Wholesale power market liquidity: consultation on a 'Secure and Promote' licence condition*, December 2012.

⁸ Reported in the FT November 2012, (www.ft.com/cms/s/0/611cc5c2-2d02-11e2-9211-00144feabdc0.html#axzz2KzXztk3y); Ofgem and the FCA are currently investigating; Barry Gardiner, *House of Commons Oral Evidence taken before the Energy and Climate Change Committee - Ofgem Annual Report and Accounts, Ofgem Annual Report and Accounts - corrected evidence* - 26 February 2013, March 2013, p 15.



nature of uncleared OTC trading it is impossible to know how much gas and electricity is traded in the wholesale energy markets. It is estimated that in 2010 the equivalent of just 10% of gas consumption and 6% of electricity consumption was traded OTC.⁹ This was considered low by some, but due to the nature of uncleared OTC trading it is impossible to know.

A final consideration is which markets should be used to benchmark prices, trades and contracts. The day-ahead and month-ahead gas markets are used to index structured gas contracts. However there is significant volatility in these markets - particularly in the month-ahead market.¹⁰ This volatility is being driven by supply side shocks, such as the Japanese tsunami, rather than demand side pressures. The volatility often doesn't translate into real changes in price¹¹, yet contracts are linked to these volatile markets and will influence consumers' prices. This does not seem appropriate. Further, the volatility increases the premium on derivatives bought to hedge against such fluctuation, and these increased costs are likely to be passed through to consumers.

Steps to reform

In order to improve the quality of price benchmarks steps need to be taken to limit or remove the vulnerabilities with the system, as well as to improve effectiveness of underlying markets. This should begin with formalising the data from uncleared over the counter (OTC) trading, which is the primary form of trading in the British energy markets, and the introduction of minimum quality standards for benchmarks as set out in *The Imbalance of Power - Wholesale Costs and Retail Prices*.¹²

Formalise the uncleared OTC and introduce minimum quality standards

Steps should be made to formalise and surface publicly the data from uncleared OTC trading. Through this, all the volumes and prices across the various OTC trading platforms would be made publicly available and could be used for market monitoring and to compile robust price indices. This could be achieved by requiring all participants in uncleared OTC gas and electricity trading to allow the OTC brokerages and platforms to publish anonymised details of all the transactions. This would limit the vulnerability in the system for gathering the price data.

To provide confidence that the wholesale price information that is being compiled into robust benchmarks, the underlying level of competition must be effective and the volumes being traded representative. Ofgem and government should develop a set of minimum standards for wholesale price benchmarks based on robust and accurate data to provide confidence in the price information. These standards should reflect, for example, the level of competition in the markets. Should the activity in a market not meet these minimum standards, clear health warnings must be provided alongside the data.

Improve the effectiveness of competition in the wholesale energy markets

Together with recommendation set out above, the Which? report *The Imbalance of Power - Wholesale Costs and Retail Prices* presents a package of reforms to improving the

⁹ 6% is based on an average of 1TWh generated every day in UK, a total annual UK generation of 370TWh in 2010 from DECC Digest of UK Energy Statistics, July 2011; 3% is based on an average of 1TWh generated every day in UK, a total annual UK generation of 370TWh in 2010 from DECC Digest of UK Energy Statistics, July 2011

¹⁰ The Oxford Institute for Energy Studies, *Natural Gas Price Volatility in the UK and North America*, February 2012

¹¹ The Oxford Institute for Energy Studies, *Natural Gas Price Volatility in the UK and North America*, February 2012

¹² Which?, *The Imbalance of Power - Wholesale Costs and Retail Prices*, July 2013, Chapter 7



effectiveness of competition in the wholesale energy markets, particularly the electricity markets. These include the introduction of a governance and management ring fence between the supply and generation businesses within vertically integrated firms and consideration of the introduction of an exchange based market maker.¹³

A ring-fence of the governance and management of supply businesses will put an end to self-supplying. This will ensure that there are volumes available for trading, either OTC or on exchanges, rather than these volumes being traded in the internal self-supply market. It will also ensure that each business within the vertically-integrated firms is able, in terms of its governance, to seek out the best prices and is subject to greater competitive pressure.

Finally, an exchange based market maker could support more effective competition in certain markets where the levels of liquidity are particularly low, thereby improving confidence in the prices derived from the markets.

Together, Which? consider these to be important steps to improving competition and transparency in the wholesale energy markets.

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¹³ For further details see Which?, *The Imbalance of Power - Wholesale Costs and Retail Prices*, July 2013, Chapter 7.