

3 July 2009

James Crump
GB Markets
9 Millbank
London
SW1P 3GE

Dear Sir,

Liquidity in the GB wholesale energy markets

Consumer Focus campaigns for a fair deal for consumers. We do this through research, policy, analysis, lobbying and by working with policy makers, providers and others who can make a difference to consumers' lives. We have a special remit to represent the interests of disadvantaged and vulnerable consumers.

Consumer Focus and our predecessor body energywatch have been concerned that wholesale energy markets have not been operating in the interests of consumers for some time. We are therefore pleased that Ofgem have undertaken this timely and important analysis of the GB wholesale energy markets. This represents one of the most important investigations into the functioning of the GB wholesale energy markets, something which we have repeatedly called for. However we would recommend that there is still more work to be done.

The comments we present in this letter address the issues of agreement and concern we have following the discussion paper's publication. We provide our views to the three different chapters of Ofgem's paper namely; Liquidity in the GB wholesale market, possible causes of low liquidity in the GB electricity market and possible measures to improve liquidity.

Liquidity in the GB wholesale market

GB wholesale gas markets

Consumer Focus agrees with the paper that the wholesale gas market is more liquid than the wholesale power market, not least because of the very different characteristics of the two markets and their very different contexts (the scale players in gas have to import and buy in bulk; they do not in electricity).

We believe that the analysis of the GB wholesale gas market is incomplete. We are concerned that the analysis undertaken by Ofgem has concentrated a little too heavily on the over-the-counter (OTC) prompt market rather than on the OTC forward market and the bilateral contract market.

More analysis should be undertaken to determine the actual volume percentage of off market long dated contracts agreed between gas majors and generators. One possible and quick to implement solution to this question could be to ask suppliers to reveal

separately how much long term and short term gas they trade openly on the OTC market and thirdly how much is traded off-market in the form of long-term bilateral contracts. This information regarding supply across these three supply options would provide the evidence to confirm whether or not suppliers are collectively refraining from trading on the forward gas market and whether or not suppliers are exhibiting anti-competitive behaviour.

We would also caution against trying to tackle the wholesale power market in isolation as there is an increased correlation between gas and power prices, as Ofgem state when discussing *Gas traded rather than electricity*¹. This means that measures to rectify the GB wholesale electricity markets may be inadequate if problems shift to the wholesale gas market.

GB wholesale electricity markets

The conclusions Ofgem have presented here about the functioning of the GB wholesale electricity markets echo the concerns we have about low levels of liquidity. A high proportion of trade occurs within integrated supply and generation firms. The trading that does exist is concentrated in prompt and shorter dated contracts with a dearth of trading far out on the forward market. We believe this has kept prices higher than they would otherwise have been if more trading activity had taken place and compromises the value of the information on forward prices. We are very concerned that these higher prices have been passed on to consumers and that your evidence suggests this problem is getting worse not better.

The wholesale market's present structure makes it difficult for new entrants to enter unless they are already large. This is because of high penalties if suppliers fail to correctly predict supply at gate closure in the electricity market which disproportionately affects smaller participants. Additionally, new supply only, or generation supply only firms are excluded from the market stifling innovation and slowing the penetration of low carbon technologies (for example Combined Heat and Power).

Consumer Focus disagrees with the conclusion made with regards to the acquisition of British Energy by EDFE and proposed acquisition of a 20% stake by Centrica that "it is not yet clear what impact this may have on liquidity"².

We are of the view that liquidity is likely to significantly decrease in the wholesale power markets due to the removal of the largest independent electricity generator from the market, who was significantly long in generation and an important source of electricity volumes for smaller players. It also removes the shortness of a major supplier. There are real risks that the two biggest market makers in the wholesale power market, EDFE and Centrica, will to a large extent withdraw from the wholesale power market, reducing liquidity still further.

¹<http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/Documents/Liquidity%20in%20the%20GB%20wholesale%20energy%20markets.pdf> p46-7

²<http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/Documents/Liquidity%20in%20the%20GB%20wholesale%20energy%20markets.pdf> p19

We have communicated our concerns on both aspects of the deal to the European Commission and OFT and have called for the European Commission to ensure that one of the conditions it placed on the merger proceeding, namely to sell minimum volumes of electricity on the GB wholesale market, is implemented. We have also urged the OFT to put in place similar measures if Centrica takes up a 20% stake in British Energy.

Possible causes of low liquidity in the GB electricity market

Consumer Focus believes that Ofgem have correctly identified a number of possible causes for low levels of liquidity and that it will be a combination of these causes which will have contributed to low levels of trading. We do however believe some of these causes will be more important than others. We are of the view that the most critical factors contributing to low liquidity in the wholesale electricity market are high levels of vertical integration, the lack of interconnection with European electricity markets and costly credit.

But perhaps a major and overlooked factor is the general or institutionalised aversion of generators to sell bulk forward volumes on an OTC basis. Again the test indicated earlier could provide useful information here.

Possible measures to improve liquidity

Consumer Focus considers the possible remedies identified in the discussion paper as useful mechanisms to improve liquidity in the GB wholesale power markets, although we believe some remedies have more merit than others.

We do not believe that the current market solutions (the introduction of a Nasdaq Nord Pool spot auction for example; as initiated by generators on the Power Trading Forum after they said that an industry led solution would be possible) will on their own solve the problem of low liquidity, especially as these remedies are focussed on improving liquidity in the prompt rather than forward market. These responses cannot be relied upon and will probably have a very limited effect.

Consumer Focus will aim to come to a more considered position and recommendation about the appropriate solutions to the wholesale power market once there is better definition and a draft impact assessment. However, we have provided our initial views on which remedies might be most effective in combating low liquidity.

At present we believe that a combination of some form of self-supply licence and auctioning system will be the best way to provide greater trading activity on the wholesale market. If these remedies are to address the defects identified (a limited, skewed market, in which many participants cannot engage) the vertically integrated energy companies must be forced to provide power of appropriate shape and volume to smaller participants and potential new entrants. To benefit smaller participants and potential new entrants, smaller volumes than currently witnessed and long-dated

forward contracts rather than short term spot and prompt contracts must be made available by the vertically integrated companies.

As Ofgem points out, these remedies will also need to be thoroughly tested to ensure that they are effective and can be properly enforced. We also wish that these remedies will enable greater levels of secondary trading rather than just trading among the Big Six, although this would be an improvement on the current situation where contracts are agreed off market.

In addition, Ofgem's proposal to require the vertically integrated energy companies to publish separate generation and supply accounts should provide greater transparency about individual firms' internal transfer pricing. This should provide for a more contestable energy market and contribute to a more liquid wholesale market.

We believe that the introduction of a market maker could have some merit in providing greater liquidity to the wholesale market, especially if it operates as a central clearing house. There is no obvious reason why this should be subsidised. We would ask Ofgem to further develop this idea to see how it could potentially work in practice. It also needs to develop its analysis of credit issues, especially in the current climate.


Finally, Consumer Focus believes that other measures, such as further interconnection with European markets, will contribute to solving the problem of low liquidity, although we would consider that these remedies would constitute more long-term solutions and would not improve liquidity where it is needed most – beyond prompt trades. We also think more consideration is needed of the interaction between the current cash-out rules and the traded markets.

Concluding remarks

Consumer Focus believes that it is essential that Ofgem builds upon the analysis undertaken in this discussion paper and more fully develop effective solutions to tackle the low levels of liquidity in the GB wholesale power market that it has shown beyond reasonable doubt are an impediment to effective competition and increase costs to consumers. It is imperative to allow all parties to procure their energy on the traded wholesale market so as to effectively operate in the electricity market as designed under the NETA and subsequently BETTA arrangements. A failure to do so penalises smaller participants and potential new entrants and protects the large and established vertically integrated firms. Over time this state of affairs will further deter new entry increasing the market power of the incumbents, which will work to the detriment of consumers in the form of higher prices.

I hope these comments are helpful. My colleague, Cem Suleyman, would be pleased to follow them up with you either in person or via telephone/email (cem.suleyman@consumerfocus.org.uk; 0207 799 7932).

Yours faithfully,



Robert Hammond
Head of Regulated Industries