CONSULTATION RESPONSE

Energy Traders Europe response to Ofgem consultation on power market liquidity

Brussels, 2 February 2024

General remarks

Energy Traders Europe, formerly known as EFET, welcomes the opportunity to respond to Ofgem consultation on Great Britain's (GB) wholesale electricity market liquidity.

We appreciate Ofgem's good analysis of the power market liquidity trend covering the years 2016-2023. We agree with Ofgem that the reasons of the downward trend are structural and minor or short to medium term regulatory interventions would have limited impact on market liquidity at best.

We believe that the Review of Electricity Market Arrangements (REMA) process is the best place to consider structural reforms and that in developing those structural reforms, the impact on power market liquidity will be an important consideration among other aspects.

In that respect, diverting time and effort to develop and implement a short to medium term intervention may even be an unhelpful distraction from tackling the important issues in REMA.

Power market liquidity trends

1. How do you consider Great Britain's power market liquidity to have changed between the suspension of the Market Making Obligation and today? What do you consider to be the main drivers of this?

We consider that the Market Making Obligation (MMO) had limited impact on liquidity. The main drivers of the downward trend in power market liquidity are structural and correspond to what Ofgem identified in the document.

The MMO led to distortions in the market by creating "fake" liquidity in the required windows as the obliged market participants had to mandatory put volume and then tried to exit as soon as possible to minimise their loss. This also exacerbated high volatility prices during the two required windows.

Whilst we recognise the correlation between the suspension of MMO and reduced market liquidity we do not consider this to be the cause. The lower levels of power market liquidity have been influenced by multiple factors, notably; geopolitical factors, increased levels of prices and price volatility, change in energy mix and a shift in UK domestic power customers from fixed price products to standard variable tariffs.

We do not believe there is a case for the reintroduction of MMO. Liquidity is the result of a well-designed market and cannot be created artificially.

While pressure has eased in 2023, the high volatility in prices of the last few years, and consequently the increase in collateral requirements had a strong negative impact on the liquidity.

2. How do you consider that trading on the spot, prompt and forward markets has changed since the suspension of the Market Making Obligation?

We agree with Ofgem's assessment that there has been a decline in forward market trading relative to shorter term trading but we do not consider the suspension of the MMO as the cause of lower power market liquidity or respective changes to trading on the spot, prompt and forward markets.

We would note that liquidity in the forward market is now more evenly spread across the trading day which in our view is better than being concentrated in dedicated MMO liquidity windows.

Since the MMO was removed we have noticed that we are able to trade more volume throughout the day rather than having to concentrate it within the tight MMO window, which allows more efficient trading to be carried out.

3. How does your assessment of current liquidity levels change when considering trading on financial products (excluded in our analysis) in addition to physical products (included)?

Financial products are negligible in the GB power market so we would not expect major differences to what Ofgem identified.

How liquidity is impacting trading

4. How has your trading behaviour changed since the suspension of the Market Making Obligation? What are your reasons for this?

No comments.

5. How do you consider that liquidity for the price cap indexed products has changed since the implementation of the default tariff cap?

We notice the impact of the price caps on trading. Suppliers want to trade the products which the cap is calculated at which reduces demand for products traded greater than 12 months ahead.

Since the implementation of the default tariff cap, we have observed liquidity for quarterly products to be less than for seasonal contracts which have always been the conventional vehicle for forward trade in the UK power and gas markets. Since the change in methodology in August 2022 to update the cap quarterly rather than seasonally, there has been some increase in quarterly liquidity.

6. How easily do you consider you are able to trade the products that you need to? Which products would you like to trade that you are currently not able to, where this can be directly attributed to the liquidity of the product?

We consider that, while liquidity can be low on some products, we can still trade on most of the offered products (with possibly more sellers than buyers).

7. What has been the cost to your business of any illiquidity that you have encountered?

No comments.

The future of liquidity

8. Do you consider that liquidity will improve or decline in the short-medium term? What do you consider will be the drivers of this?

It is difficult to foresee. Interconnectors should improve liquidity if trading will be extended to the intraday and forward timeframe.

Also, the recent launch of Y+2 and Y+3 products on some interconnectors (like IFA/IFA2) could help adding liquidity on the Long-Term market as market participants would tend to hedge directly on the market after cross border capacity auction results.

Furthermore, a potential full price recoupling with the EU/SDAC would help to improve liquid in the GB market.

The electricity market might also evolve and grow in volumes with the electrification of consumption, but this could be counterbalanced by energy efficiency policies.

In the medium to longer term, any move toward introduction of LMP (either nodal or zonal) could have a significant adverse impact on liquidity.

Potential intervention options

9. Given the levels and drivers of liquidity, do you consider that liquidity intervention in Great Britain's power market would be justified in the short-medium term?

There are three areas where there is broad consensus on the need for changes and where immediate action to improve the situation can be taken to the benefit of consumers:

1. Recoupling the UK exchanges in day-ahead to provide a more robust price signal. EPEX SPOT and N2EX should re-merge their order books and organise a single auction in day-ahead as soon as possible. This would be a pragmatic, no-regret solution in consumers' interest, as the current situation has led to a material decrease in day-ahead liquidity, greater operational complexity (incl. impact on

cross-border trading), and hedging difficulties. Once this is done, this coupling could be extended to intraday as well.

2. Delivering more efficient cross-border trading arrangements with the rest of Europe. As also recognised in the REMA consultation document, interconnectors are an important source of flexibility and security of supply. Therefore, we would encourage greater cooperation with EU neighbours. We would also urge for the improvement of trading arrangements on the NSL cable with Norway, where currently there are arrangements only for day-ahead trading–it would be important to put in place intraday and forward trading arrangements as a matter of priority.
3. Strengthening the UK ETS and linking it with the EU ETS. A strengthened and expanded UK ETS would have an enhanced role in driving the decarbonisation effort across the UK economy. The current lack of liquidity can be overcome by linking the UK ETS with the much larger and a lot more liquid EU ETS. We understand that the issue is compounded by the broader discussions on the post-Brexit relation between the UK and the EU, but there is a clear benefit to both sides of linking the two schemes. Moreover, linking would address any potential issues related to the implementation of the EU Carbon Border Adjustment Mechanism (CBAM).

Most importantly, we believe Ofgem's primary consideration should be to avoid any further reduction to current liquidity levels, for example as an unintended consequence of other policy interventions.

10. What market-led approaches could be used to improve liquidity?

Renewable PPAs have a comparable effect to government CfDs for renewable energy developers, as they provide revenue stabilisation over a long period of time, which helps to obtain finance and reduce the cost of capital. At the same time, they remove the potential for market distortion of support schemes, as they are commercial contracts and do not take away all risks from the contracting parties: e.g. the balancing risk needs to be managed; incentives for hedging are maintained, which reduces the impact on forward market liquidity.

The regulatory environment could hinder the growth of renewable PPAs. Therefore, it would be essential to make sure that the revised low carbon power support mechanisms are complementary to and do not undermine incentives for the growth of commercial PPAs for renewable energy. It would also be helpful to improve the uptake of renewable PPAs among industrial consumers, SMEs, municipalities, etc. To this end, facilitating aggregation and addressing counterparty credit risk issues (potentially by providing help with credit guarantees), where required, would be needed.

The retail market may move towards more fixed term products if prices reduce and this would lead to a greater demand for longer-dated products.

11. What regulatory interventions do you think could be appropriate to improve liquidity?

Considering shortening the market time unit (i.e. 30 minutes at present) and/or moving gate closure closer to real time – benefitting flexible capacity and demand response.

Consolidating the number of ancillary services markets, making information more clearly available and enabling participation by a broader range of market participants.

Remove the retail price cap or set it against a wider time period such as 24 months rather than 12 months.

12. If intervention was required, what would your preferred option be? What benefits would this bring to your business? Where possible, please quantify these benefits.

Before any intervention, market participants should be consulted on any options that OFGEM/DESNZ would like to implement.

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