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SEM Consultation Response SEM-16-030

Measures to promote liquidity in the I-SEM forward market

Vayu welcomes the opportunity to comment on the SEM Committee's ("SEMC") consultation paper – SEM-16-030 on measures to promote liquidity in the I-SEM forward market. Vayu believe that this is one of the most important consultations in the process to deliver I-SEM. Without an active and liquid forward market, we believe I-SEM will fail to deliver many of the benefits expected of it in terms of a market that functions for the benefit of all participants and consumers.

In this consultation response, we would like to make a number of general comments on the assumptions in the consultation, before providing our answers to the six specific consultation questions and making some specific comments on the content of the paper.

As a general comment, Vayu would prefer not to have this discussion restricted to five narrow pre-defined options as this inappropriately narrows discussion and debate on this important issue. The individual measures presented are all worthy of consideration and we present a number of other suggestions to help in achieving the objective of improved liquidity in the I-SEM market.

However, we take the view that all the measures should be considered on their merits individually and, ultimately, as a coherent package. We do not regard it as appropriate that introduction of individual measures should be made contingent on the introduction or removal of others without clear explanation and discussion on the reasons for this. In particular, we do not see any circumstances where it is correct to remove vertical ring-fencing without clear evidence that liquidity has developed in the forward market. As a result, we would ask as a minimum that the Regulatory Authorities re-visit the 'Option 2' presented and include a Market Maker Obligation in addition to the measures included in this package.

We would also urge some urgency in concluding the consultation and introducing measures to improve forward trading and liquidity; October-17, the scheduled start date for SEM is already within the timeframe of customers seeking contracts of greater than one year duration.

In addition, as a specific comment, we would ask that the Regulatory Authorities base their assessment on the different proportions of hedging undertaken by market participants (presented on p48) on more detailed analysis and discussion with market participants. It is unacceptable that such critical figures, defining the volumes of hedging contracts that will become available in the market, appear to be based on little more than guesswork.

Finally, particularly for longer duration contracts with their associated larger volumes and values (e.g. seasonal or annual contracts) we would like to see a smaller lot size of 100kW rather than 1MW. This would

provide greater access to the products and the wider market for all participants, enhancing overall liquidity through their aggregate actions.

As always, we would be pleased to discuss this response and the issues in the consultation paper directly with you, either in a meeting or by telephone. Please do not hesitate to contact us if you require any further information or explanation of anything raised in this response.

Response to Consultation Questions

1. **Does the Consultation Paper correctly set out the nature of the problem to be solved? Is it correct that the lack of liquidity characteristic of the SEM will not be satisfactorily rectified through incentives inherent in the I-SEM design?**

The paper broadly identifies the nature of the problem to be solved; a need for forward hedging instruments and a liquid market for trading these instruments to ensure the I-SEM could be deemed to be successful overall as a market.

The I-SEM design should provide for increased liquidity in the spot market at least. Introducing active bidding on the demand side and creating a system where generators must buy to cover sales commitments where they cannot generate will lead to a better functioning spot market, which, in turn, has the potential to create more liquidity in forwards over time. However, an improvement over the current woefully inadequate levels of liquidity in the SEM forward market is not sufficient to claim success.

Replacing one spot trading mechanism (SEM Pool) with another (I-SEM prompt markets) does nothing to address fundamental problems in the overall market structure that will act to stifle liquidity. Bilateral markets are generally successful, in terms of having correctly formed prices and a high degree of market trust and liquidity in trading, where they have a diverse range of willing buyers and sellers. SEM has been typified by a small number of participants, some with an overwhelming degree of market dominance and vertical integration in a market with limited scale and an extremely low level of elasticity of demand. As such, it has required a strong degree of regulation (Market Monitoring and Bidding CoP) to deliver prices that approach a 'fair' level and has delivered next to nothing in forward liquidity, even taking account of the regulated DC sales.

There are few reasons to assume that I-SEM will be any different, at least in the initial few years, and, failing any process to reduce market concentration and dominance, we see a need for continuing regulation and additional measures to promote liquidity in the I-SEM forward market.

2. **Does the scope of the Consultation Paper set out the full range of potential liquidity promotion measures that should be considered for implementation? If other regulatory interventions are considered appropriate please set out the nature, rationale and parameters of such intervention.**

The Consultation Paper sets out a broad range of measures that could be considered for implementation to promote liquidity and we welcome these. A Forward Contract Selling Obligation on generators, with a transparent auction-based pricing mechanism and generators as price takers, offers a significant improvement over the current DC process. Market Maker Obligations will also support re-trading of contract purchases and proposals for a central exchange and clearing further support this objective. Vertical ring-fencing goes some way to preventing significant volumes being traded 'off-market' and, in our view, there should be no consideration given to dropping this measure unless liquidity is proven to develop over a given minimum timeframe.

Absent any proposals to restructure the number and form of participants in the market, we would propose six additional regulatory interventions.

1. Create a standard, balanced CfD trading Master Agreement for I-SEM and mandate that all larger participants sign on standard terms with other participants. Negotiations over trading agreements can take extended periods of time and would provide an easy means for dominant participants to delay access to the forward market for smaller participants, securing a competitive advantage in the process. Having these agreements negotiated and executed well in advance of I-SEM opening will greatly facilitate bilateral and exchange based trading and support market liquidity. Although there

are current master agreements for trading DCs and NDCs, these are heavily based on the Directed Contract template and, therefore, tend to favour the seller/generator and we would prefer a genuinely bilateral master agreement template to be made available.

2. An additional measure to promote price transparency and liquidity would be to provide for compulsory reporting and prompt publication of bilateral trading (suitably anonymised to protect participants' commercial confidentiality).

3. The regulatory authorities should take an active role in ensuring that demands on participants for credit cover are proportionate and reasonable. Again, requesting extreme levels of credit cover and refusing to offer any unsecured credit for forward purchases forms a means for dominant participants to put a brake on market liquidity while still appearing to be reasonable and supportive. We note that Ofgem has taken similar steps in BETTA with the 'Big 6' participants in its 'Secure and Promote' licence conditions on participants in order to improve market liquidity. For similar reasons, we believe that this type of intervention is appropriate in I-SEM to deliver improved liquidity.

4. Access to Interconnector capacity in SEM forms one of the more open and transparent mechanisms for non-dominant participants to hedge their forward position by providing access to the more liquid BETTA market. I-SEM will replace interconnector capacity with FTRs but they will provide a similar function; material reduction in basis risk when proxy hedging in the BETTA market.

   We believe that it would be appropriate to restrict or prohibit dominant participants in I-SEM from FTR purchases to prevent them from restricting access to this market for other participants and forcing them to conduct their hedging solely with I-SEM forwards purchased from those dominant players. As a minimum, we would expect that smaller participants should have first rights to access FTRs as a hedge, in advance of any involvement of larger, dominant generators in their purchase.

5. The Consultation paper suggests that it is reasonable to expect market participants to hedge their positions using contracts in the gas market. This is not completely unreasonable, but it must be recognised that this still leaves a material basis risk between fuel and power prices.

   We believe that, in addition to the proposed access to outright power forward hedge suggested in the paper, participants should be given access to hedges on the fuel/power spread, provided by the dominant participants. These products would be lower risk than outright sales, because of the correlation between gas and power prices supported by regulatory measures over market power. The dominant participants, with their greater financial strength, should be able to offer these products without any reduction in forward power hedge obligations.

6. In seeking a provider for any exchange and clearing house services, the RA's should consider whether they can offer offsetting of collateral or margin payments with related exchanges. This would reduce the cost and risks to participants offering to sell contracts in the I-SEM that offset their risks with purchases in the BETTA or gas markets (or vice versa).

   In other words, where there is a strong correlation between I-SEM price movements and those in the gas market, a participant with a long I-SEM position and corresponding short gas position would benefit from offsetting price movements on each position and reduced margining requirements as a result. This process of 'cross-margining' is common within exchanges where traders commonly hold positions in multiple products, see, for example, the London Clearing House Clearnet manual.

Finally, we would re-iterate our opposition to abandoning vertical ring-fencing as a measure to promote liquidity, unless and until satisfactory liquidity has been demonstrated for an extended period of time in the I-SEM market.

3. Respondents are asked to provide their views on the rationale, parameters and potential effectiveness of each of the regulatory interventions described and explained in the Consultation Paper.

Given the concerns from industry during the market power process, we believe that retention of vertical ring-fencing is the most important regulatory intervention to protect and develop liquidity in the I-SEM. Markets are successful and liquid where there is a diverse range of willing buyers and sellers and vertical integration of dominant market players works in direct opposition to this outcome. As such, we believe vertical ring-

fencing should be retained on the dominant market players until it is demonstrated that liquidity has developed in the forward markets, for a given minimum timeframe.

Establishing a central market platform will help concentrate liquidity in a transparent location. Establishing a clearing house will assist in reducing credit risk to participants – often a significant barrier to market entry or the source of material premiums to contract prices. We welcome both these initiatives and believe they will be effective in promoting liquidity in the I-SEM market. However, they are not a single all-encompassing solution, as the consultation seems to suggest. Ensuring that participants have fair access to equitable bilateral contracts with reasonable credit terms would further support these aims, as detailed in our response to question 2, above.

Providing guaranteed, accessible volumes of hedges to non-dominant market participants is vital to protecting their businesses and providing for the establishment and growth of effective competition. To this end, we believe that the process of providing access to Directed Contract volumes should continue, with the obligation to provide these volumes placed on the dominant generators. However, we do not believe that the current SEM pricing mechanism has been a success, as it is primarily designed to protect the margins and reduce the risks of the supply side of the market. We believe that pricing by reference to an alternative market or auctions would be an improved method to establish the price of these contracts.

In addition, we would like to see purchasers given the option to draw down only part of any DC allocation, with smaller clip sizes of 100kW rather than 1MW, rather than have to take or leave the entire volume. Any DC volumes that are not taken by the supplier they are initially allocated to should be moved into the Forward Contract Selling Obligation or offered to other suppliers as appropriate.

A Forward Contract Selling Obligation, as proposed will be an additional effective measure to secure access to hedging contracts and promote competition and liquidity in the I-SEM forward market. This FCSO could work in support of compulsory DC volumes to provide access to hedging contracts for participants and begin to establish more continuous liquidity (i.e. liquidity beyond defined auction dates or windows). We would request, however, that this FCSO is underpinned with better analysis and consultation than presented in the (square-bracketed) figures on page 48 of the consultation paper. Unsupported allegations that all suppliers would 'reasonably wish' to be 10% unhedged at delivery is not acceptable.

Finally, a market-maker obligation ("MMO") is also likely to be effective in establishing continuous liquidity in both directions (i.e. buying and selling contracts) in the I-SEM forward market. This has been highly effective in the BETTA market in securing and promoting access to the market for new entrants and should certainly be introduced in the event that other measures fail to introduce sufficient liquidity. The consultation paper provides a well thought out analysis to provide a starting point for establishing an MMO and we would support the use of these parameters at its introduction, provided there was some flexibility to increase or relax obligations as liquidity evolved over time.

4. **What are the important issues to be considered in each of the options? In what way might the options be made more effective? Please set out your views on the rationale for, and value of the parameters employed to determine, the quantity of the obligation in each option.**

The important issues to be considered in this discussion of measures to improve liquidity are two-fold. Firstly, will a measure or regulatory intervention increase transparency and competition in the I-SEM market and/or provide immediate liquidity. Secondly, will a measure or regulatory intervention create confidence in the market such that it will increase liquidity over time either by attracting new participants or allowing market participants to take on risks in the market with the knowledge they will be able to cover those risks without incurring unsustainable losses.

Market participants should be confident that measures or regulatory interventions will be reduced or fall away as liquidity in the forward market develops. Similarly, participants should be confident that the regulatory authorities will be proactive and will introduce new or more stringent measure or interventions if liquidity fails to develop. As stated in our introductory paragraphs, we do not believe that discussion should be restricted to the options presented and we expand on this in answer 5, below.

5. **What is the preferred option and why do you consider it preferable?**

We do not believe that this discussion should be restricted to the five pre-defined options presented. Framing the discussion in this way appears to be a deliberate tactic to discount alternative options or combinations of measures. Therefore, none of the options presented are preferable as we do not see the various elements of regulatory intervention as being mutually exclusive in the way they are presented.

Vayu would prefer an option where Directed Contract volumes are allocated fairly to suppliers (with a price set by auction rather than the current mechanism), a Forward Contract Selling Obligation exists on generators and Vertical Ring-fencing is maintained on dominant market participants. A Market-Maker Obligation should also be considered, particularly if other measures fail to deliver liquidity, but this should not be contingent on removal of vertical ring-fencing.

Allocating DC volumes guarantees that suppliers have access to some volume of hedging to allow them to compete in the retail market with an acceptable degree of risk. The current mechanism for pricing has been designed to maintain margins and eliminate risk for generators and should be abandoned. Allowing prices to be set through an auction process (or with reference to auction results from auctions held from the FCSO) would allow prices to be set with reference to consumer sale prices, encouraging more open an transparent competition between suppliers.

A Forward Contract Selling Obligation would further these aims and could underpin access to hedging volumes on a more continuous basis rather than at defined sale periods. An MMO would build on this, allowing market participants to sell off hedges (either to take profits in the event prices rise above their expectations or to liquidate volumes beyond their requirements if their sales volumes fall).

With the limited scale of the I-SEM market, the clear issues of market dominance by certain participants and the low probability of new market participants (particularly asset-less traders), we do not believe that it is appropriate to even consider dropping vertical ring-fencing measures unless and until liquidity in the traded market is demonstrated.

6. **What parameters of the regulatory intervention option should be determined by the Regulatory Authorities and which should be left to market participants to determine?**

We believe that volumes of contracts sold as Directed Contracts or included in Forward Contract Sales Obligations or Market Maker Obligations should be determined by the Regulatory Authorities. This would overcome any natural tendency by dominant participants to be parsimonious in volumes offered to their ultimate competitors. In determining these volumes, the RAs should take account of the level and profile of unserved demand for these hedging products, both by considering the market's capacity to provide them and by consulting with participants themselves as to their requirements. For example, there will naturally be less demand for longer dated and larger volume products and less demand from suppliers for products defined according to generator's specifications, such as the SEM Mid-Merit contract. (we would also suggest that a proliferation of different product structures and definitions acts against the promotion of market liquidity as the different products are not fungible).

We believe that prices should be left to market participants to determine, noting the limited appetite for taking up Directed Contract volumes priced by a non-transparent mechanism that is not related to market demand or end-user prices. The dominant position of some participants on the generation side of the market means that generators should, for an initial period at least, be price-takers in this process.

Comments on Consultation Paper Content

- **Introduction P7**. The paper provides an excellent introduction on why liquidity is important and the benefits it provides to the market. We would have welcomed some examples of successful markets and how liquidity has developed in them to support the identification of appropriate measures to promote liquidity. For example, oil markets have good levels of liquidity because they comprise a diverse range of willing buyers and sellers and barriers to entry are low.

- **P12**. The 'Market Change' point isn't well constructed. A party that enters into a hedging contract that subsequently makes a loss should be satisfied with this, if it is a genuine hedge, as they will be gaining equivalent value on the offsetting position. An exception to this would be where the hedging contract is margined and the losses must be immediately posted in cash, while the gains on the offsetting position may only arise over time.

- **P14**. A gas fired generator that hedges its gas price, but not power sales is actually at greater risk than a generator that does nothing. Generation is an option on the spread between fuel and power, with its unhedged risk limited to fixed costs. The volatility of a single commodity is greater than the volatility of the spread between them, where their correlation is greater than zero (as is the case for power and gas.)

- **P16**. It is not correct to exclude Interconnectors from volumes available to hedge. Purchase of interconnector capacity and forward power in GB is probably one of the best and most easily available sources of hedging in the current market for non-dominant suppliers

- **P23. (Last para.)** It doesn't necessarily follow that increased volatility will lead to generators having a greater desire to hedge as they have the option not to run if prices/spreads get too low.

- **P24**. References to Scotch Power and the Scotch side of the interconnector should be ScottishPower and the Scottish side of the interconnector.

- **P26**. Section 3.7 introduces some important points on credit and the need for Ofgem to intervene to create liquidity in the GB market. Following some of these actions from Ofgem would make great strides in introducing liquidity into I-SEM. Creation of a standard I-SEM CfD Trading Master Agreement would also help reduce barriers and costs for participants.

- **P27**. The suggestion of central collateral provision and netting is useful in reducing costs and risks to participants. In addition, some degree of socialisation of losses and/or credit default insurance (either from an external provider or organised within the market) would further these objectives.

- **P29**. It is not correct that Directed Contracts mandate ESB to sell volumes. ESB is only mandated to offer these volumes to counterparties and ESB retains the volumes if they elect not to take up their allocation.

- **P30**. It is important to note that DCs only reduce, but do not eliminate, any incentive on ESB to submit non-competitive prices into the spot market. ESB could be comfortable taking a loss on the relatively small DC volumes if that was offset by a much greater gain on uncontracted generation.

- **P37.** It is correctly noted in the last bullet point that I-SEM will be an immature market. Liquidity in markets evolves over time and this should be recognised. Proposals should be considered for both the initial period in I-SEM and enduring measures (e.g. reducing mandatory contract sales over time as liquidity is demonstrated in the market).

- **P41.** Exchange based trading and clearing does reduce credit risk for participants, as is noted elsewhere in the consultation paper. However, it does introduce an element of cash-flow risk to participants, particularly where hedging is taking place in large volumes on longer dated contracts and this should be recognised. (Cash flow risk occurs where a participant must immediately pay a margin call on a hedging contract while the gains on the offsetting position may not crystalise until delivery in the future).

- **P45.** Suppliers need access to longer-dated (seasonal, annual, multi-year) contracts to hedge tariffs that meet customers' requirements for longer-term price certainty. Evidence of DC contracts sales, with their artificial contract prices, provides no evidence of the demand for hedging contracts under I-

SEM. Again, rather than being based on contract structures and volumes that suit the generators or sellers, the defining of volumes and profiles available for hedging should be driven by the needs of suppliers to manage risks taken on in order to service the requirements of their customers.

- **P47.** The paper seeks a voluntary provider of exchange/clearing services for the forward market. Is there a fall-back plan if this does not materialise? We would expect to see provision for some further measures if there is a more organic start to the market without an established exchange/clearing house.

- **P48**. The square bracketed numbers for hedging levels look like guesswork with no analysis behind them. It is suggested that 10% unhedged level for suppliers at delivery is 'reasonable' with no justification behind it. A quantitative impact analysis of this, based on different levels of price volatility, should be made to ensure that there is sufficient stability in the market (i.e. that suppliers will not fail or require to charge unreasonable premiums in their tariffs to cover risk). If it is being suggested that suppliers should take basis risk on fuel or GB power products, again analysis should be provided to ensure this is sustainable and competitive. In addition, access should be reserved for suppliers on the interconnector or FTRs (i.e. generators excluded from this market) and to appropriate hedging products on the fuel-power spread if these risks are judged to be unacceptable. We would ask that figures used in these critical values defining the volumes of contracts available for hedging are based on more detailed analysis and discussion with market participants.

- **P50**. The logic that leads to the conclusion that less baseload volumes should be provided as a result of offering products in the 2/1/1 ratio is not clear. We would re-iterate that volumes of DCs sold in SEM, with their artificial pricing mechanism, do not provide a useful guide to requirements and demand under I-SEM. Furthermore, we believe this is inconsistent with the view that most liquidity in other power markets concentrates in the baseload product and would undermine efforts to get liquidity established in this product.

- **P50**. We would ask for clarification that it is 2 x 1MW lots on offer from generators, which would help liquidity, rather than individual '2 MW lots'. We would also prefer the market to provide for smaller clip-sizes, i.e. 0.1MW or 100kW size deals to provide greater market access for smaller participants.

- **P53**. MMO – We believe that the requirement to impose a Market Maker Obligation is recognition that market power is overly concentrated and that other steps should be taken to address this by creating a greater number of willing buyers and sellers in the market.