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Open (almost) all hours—the need to reassess trading

If the problems facing merchant supply in Britain were not real enough, the recent failure of two electricity companies—Electricity4Business and Bizz Energy—has raised some basic questions about the viability of independent retailing in the current market environment. Both argued that access to wholesale product constrained them, so in this *Energy perspective* we take another look at the issue of market liquidity, and how trading options might be improved. We conclude that the problems besetting smaller players have been exacerbated as much by market rules as the "credit crunch."

One foot in the grave

The timing of the failures is bitterly perverse given the appearance of the Ofgem price probe in early October. That report represented a first formal acknowledgement by the regulator that there were real issues about the functioning of British wholesale power markets, and implicitly how these impact on those outside of the Big Six. This recognition also heralded a commitment from Ofgem to address urgently with the integrated companies how liquidity in the markets, especially electricity, might be stimulated and how market barriers and distortions might be tackled.

At the time there was palpable relief from the smaller companies that at last some of their concerns about the state of the market were being discussed. It is no coincidence that the failed companies were two of the three that called loudly for wholesale market reform during the Berr committee's energy review earlier this year.

But the relief was short-lived as the credit crisis deepened, and the two companies found themselves trying to refinance their activities at the same time as the collapse in bank lending. In a market where the scale players are reluctant to sell to parties with a lesser credit standing than themselves without full collateralisation of purchases, both Electricity4Business and Bizz Energy found it increasingly difficult to back-off their sales, in effect causing them to go short. With imbalance bills escalating and banks not prepared to lend further, it was only a question of time before credit was exceeded. Having to write a large cheque to buy out their 2007-08 renewables obligations was probably the final nail in the coffin.

Ever decreasing circles

Consequently these failures have underlined again the importance of liquidity—the depth of trading in the market place––especially to independent supply. By definition, independent suppliers have either no or limited access to generation, and are dependent on upstream players and traders selling to them. If they cannot source the volumes *and* the shape they need, they are pushed into energy imbalance and are cashed out at prices that are meant to be cost-reflective but which in practice are penal.

And energy supply is in essence a business focussed on cash flow and its management. Executing forward trades is the mechanism for backing off price risk when entering new retail deals, allowing suppliers to lock in their margins. Against this backdrop successful suppliers are those that differentiate themselves from their competitors by offering better service, who ensure they can bill accurately and collect payment in a timely manner. But if they cannot gain access to energy on fair terms, they can only operate at a further competitive disadvantage in a market that already rewards scale.

So, if suppliers, for whatever reason, cannot source product as they commit to sales, the business risk can be exponentially greater, their working capital requirements increase and growth can be curtailed. And the greater the working capital requirement becomes—especially with escalating credit restrictions—the more severe the pressures on the business.

As time goes by

But there are widely differing views on what constitutes healthy levels of trading. Based on these views and various publicly available sources, we recently attempted to reach a view on the extent of trading in the British wholesale markets and associated trends. The bottom line is that perhaps up to four times the underlying physical quantities were traded in 2007-08. What the analysis also shows clearly is the way liquidity can ebb and flow. The level of trading fell

dramatically in the early Neta period following the failure of Enron and TXU, both very aggressive trading parties. There is a consensus view that the low point was reached around 2005, but matters picked up thereafter.

In interpreting the available data, it needs to be remembered that it is backward looking and often lagged, and some traders have recently cut back their activities. Some like Lehmans have themselves failed. Others have seen their own credit standing downgraded, while others have tightened up on their trading limits. Those that continue will often usually only sell to parties that have investment grade credit ratings. What this means for trading multiples is difficult to say yet. But for arguments sake let's assume that trading reflects in excess of three times the underlying physical quantity (in other words each kWh delivered is bought and sold three times).

Not only but also

There are variables other than the economic downturn going forward that might impact levels of trading, not least of which is what could happen if British Energy were acquired by EDF Energy. Two polarised views have emerged.

The first is obviously that the loss of a major independent generator will remove a valuable source of liquidity from the market. Welsh Power, operator of the Uskmouth coal station and owner of business supplier Haven Power (and the third of the companies that actively lobbied the Berr select committee), has advanced this argument. Its chief executive Alex Lambie wrote to the Government on the day the offer was made saying his company was "amazed" it had appeared to have agreed "without any fight" despite "well-documented competition concerns."

Lambie wanted any EDF purchase of British Energy to "be delayed until a full investigation into the whole sector has been concluded by the Competition Commission". Should the deal close, EDF would have more than a quarter market share, he claimed. He also called for EDF to be required to divest plant and development sites as conditions of proceeding.

These themes were amplified in a press release from Welsh Power issued on 8 October. Lambie said: "British Energy... has been quoted as saying that [the company] did not expect liquidity to decline on the basis that EDF has a better credit rating than British Energy. This suggests a fundamental misunderstanding of market liquidity. It is not simply about the credit rating of the companies in the market, but their willingness to trade their products through the markets." He added: "Sale of British Energy will mean one less player selling in the market. It also means EDF can meet more of their supply requirement from their own generation, which means they have to buy less power from the market."

There is a counter-argument that consolidation could *improve* liquidity given the current position of British Energy. Its strategy head Paul Spence was reported by *Platts* on 3 October saying that the proposed purchase of the company by EDF should not adversely affect wholesale power market liquidity in Britain. He also said liquidity would improve with EDF's plans to build four new reactors guaranteeing liquidity over the long term. "The hope and expectation is that by being part of a much larger group, we will be able to guarantee future supply and keep the stations running."

And over the short-term, although Spence did not say how much output would be sold into the market as opposed to supplied directly to EDF Energy, he did say the new group would be able to take a more active presence in the power markets than British Energy alone. "The new group will have a much better credit rating, which will release that constraint and allow for more trading in the markets."

Of course it has been widely reported that a further transaction involving a later sell-down of equity or output from any new merged entity to Centrica could occur, further taking valuable liquidity off market. But it is important to remember that any such deal would not be pursued until the primary transaction has been confirmed—so the policy debate on liquidity effects needs to occur now. And the answer to the question of who will be proved right will only be known if and when the transaction proceeds.

What strikes us is that no-one seems to have an answer to the *key* question of what actually represents a good level of liquidity. Is three times or four times underlying volumes healthy given the specific conditions of the British market-place? What durations are involved and how should this influence the assessment? Sweeping statements are often made based on international comparisons with heavily interconnected markets. Some markets with higher trading multiples have these because of different institutional arrangements and they lump in mandatory markets. Others have more liquid wholesale trading (based on static comparisons of multiples), but less healthy retail markets.

Rising damp (the wrong kind of liquidity)

But having a healthy market in short-term power (say hours and days) does not help a new entrant supplier looking to match its risk for an annual contract. And availability of seasonal power is little use if a supplier is trying to avoid imbalance, but as can often be the case no short-term quantities are available. Further it is one thing being able to access baseload power but the risk of exposure in shoulder or peak periods still needs to be dealt with. This is why "shape issues" remain a real concern to many independent purchasers.

There is enough in these arguments to explain why the Berr select committee and Ofgem have been right to highlight liquidity issues, and why the issues are much more complex than whether one participant should acquire another.

All gas and gaiters

The foregoing also explains why we are concerned that short-term focuses such as this will distract from other no less fundamental issues of credit in the market-place and the interaction of trading with current market rules. Even if there were abundant pools of liquidity and shape were not a problem (which is clearly not the case), it is unlikely that the position of many of the smaller suppliers would be notably better. Rising prices and increased volatility amplified by multiple credit calls have exponentially increased the cash flow demands on industry participants tying up valuable working capital and increasing funding requirements. This is not a new phenomenon; it is deeply embedded. But as the credit crunch has taken hold, available funds have tended to dry up in a business where there is always a significant gap between the timing of outgoings and incomings.

Similarly it is not a recent development that big players have been reluctant to sell to smaller ones. It has long been the practice that many of the larger players are simply not prepared to do business with smaller players as they fall outside their self-administered credit policies—even where full collateralisation of purchases has been offered. Added to this some of the smallest participants, including some of the few most recent new entrants into supply, are simply not of sufficient size that selling parties would look to trade with them.

Given this wider definition of the problem, any measures to stimulate trading volumes as proposed by the Berr committee are unlikely to make a significant or early difference. And while the recent announcement by APX that it plans to open a day-ahead market is to be warmly welcomed, and it may provide a valuable short-term trading option, it will not provide small parcels of power that many of the smaller independents seek over longer durations. The bottom-line is that smaller participants simply do not have natural counter-parties in a market dominated by scale players.

Whack-o?

So as well as seeking ways of stimulating trading, it is imperative to address those aspects of the market design that amplify volume risk, which aggravate the effects of being in imbalance and which inflate credit requirements, including:

- **Extending the market to as close to real-time as possible**

The industry has begun to discuss the pros and cons of moving Gate Closure but without enthusiasm. The real issue here is not primarily about changing physical notification timescales but how to allow more time for parties to contract in the short-term markets, and whether there are mechanisms for those parties from whom National Grid does not need binding notifications which might permit creation of some form of liquidity pool to pre-empt imbalances—or even perhaps trade them

- **Rationalising settlement**

Perceptions of credit risk are amplified by the length of time it takes to settle transactions, especially through the central processes, and there are many inefficiencies in settlement procedures. There are also multiple, sometimes overlapping credit arrangements with significant (some would argue excessive sums) tied up in network credit. Because of the fragmented nature of the current arrangements, little attempt has been made by the industry to look at the matter in the round. For instance can settlement timescales be rationalised, and is there scope for more coordinated clearing?

- **Remove remaining distortions in cash-out**

This requires (and will receive) a further comment on its own from us. Assuming P217A does address a large part of current levels of pollution in cash-out, we will not know for two years (as implementation will not occur before November 2009 and Ofgem has asked for a 12-month review), and it is likely to take at least another two years to agree further changes and then implement them. We have long held that there is a strong case for some level of tolerance bands on the system, as all parties unavoidably see some degree of imbalance that is predictable to the system operator, especially in a market where half-hour settlement and profiles are integral features (that is the imbalance arises as a consequence of other market rules).

The risks arising from these market mechanisms are much more pronounced for decentralised and smaller players on both sides of the market, and need urgent consideration and, we would argue, rectification.

All in all we conclude that liquidity is and will remain a problem. This arises not simply from the quantum of trading in the market. The real focus should be on the quality of trading and how it is impacting on different classes of participant. Trading is a means to an end, and what really matters is the ability of participants to manage their risk without discrimination, affordably and free from arbitrary market distortions.

Maybe some of these ideas set out in the Energy perspective may seem a little far-fetched. But I would argue it is more surprising that there is such a dearth of thinking on issues that have long been known to introduce cost and complexity

into the market, and the resistance of many established players to debate these issues is now posing real challenges for industry governance and its credibility.

What is becoming clear is that there is an increasing expectation among policy makers that trading arrangements whatever their detailed rules will become more accessible to new types of participant and technologies. But the reality is that the strong incentives at the heart of Neta are creating a dynamic that depends on consolidation and scale, and they perpetuate it. The credit crunch is simply accelerating a process of contraction that has been well underway since 2001. Electricity4Business and Bizz Energy are the latest casualties, but unfortunately they will not be the last.

What we need now is to think hard about how trading rules can be modernised to stimulate and broaden trading options and how the central processes can be adjusted to support this, while allowing National Grid the necessary mechanisms to deal with what is actually happening on the busses.