Optimised Energy

2014
introduction of MMO

3
target areas for MMO

Liquidity of UK Wholesale Energy Markets

Liquidity is a measure of how effectively a product can be purchased or sold without any substantial change in price or significant transactional costs. Put simply, liquidity is product availability.

Liquid markets have large numbers of buyers and sellers and trades can take place at any time. This improves competition, as many types of businesses can enter the market and vertically integrated participants, i.e. a supplier with generating assets, are no longer necessarily at an advantage.

Highly liquid markets can have knock on benefits for all market participants. For example, prices on a liquid electricity market can react quickly to changing market conditions, thus allowing consumers to make more efficient assessments with regards to both consumption and volume required. In turn, this provides more accurate investment signals to market participants, such as generators, transporters and storers.

Measuring Market Liquidity

There are several ways in which market liquidity can be assessed. A key indicator of liquidity, which is used by Ofgem in their liquidity assessments, is the churn rate. Churn rate is a ratio between the number of transactions to physical demand. A high ratio is an indicator of a liquid market.

The spread between the bid and ask prices can also be used to indicate liquidity. A lower bid/ask spread means bidders' expectations on price are in line with the sellers. As a result, transaction costs are reduced, and those transactions will take place more frequently. Currency markets are the most liquid markets in the world with bid/ask spreads of as little as 0.001%.

BID
The price a buyer is willing to pay

ASK
The price a seller is willing to sell for

Quick Facts

Liquidity is a measure of how quickly a commodity can be purchased or sold without causing a drastic change in price

Liquid markets benefit all market participants and provide more accurate investment signals

Ofgem introduced the Secure & Promote Market Making Obligation (MMO) in 2014 to try and improve liquidity

The MMO was suspended in 2019 and initial Ofgem assessments indicate liquidity has not been significantly effected

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Secure and Promote Market Making Obligation (MMO)

The MMO was introduced by Ofgem in 2014 to improve liquidity on UK energy markets. The obligation was implemented by incorporating certain conditions into supplier trading licences, specifically the licenses of the six largest vertically integrated market participants, i.e. the 'big six.'

The measures were designed to target three areas: market access, product tradability and reporting on near-term markets. To improve market access, the 6 largest generators were obliged to consider trading agreements from smaller suppliers. Two, hour-long 'liquidity windows' were introduced meaning large suppliers had to make certain products available to trade from 1030 to 1130 and 1530 to 1630 each day. Finally, the target participants had to provide reporting to allow Ofgem to monitor near-term markets more effectively.

Suspension of the MMO

During the span of the MMO, the 4 of the 6 largest generators, sold or transferred generating assets and so they no longer had an obligation to take part. By May 2019, only there were only 2 participants left under the obligation: EDF Energy and SSE. As a result, Ofgem announced that they would be seeking to evaluate the effectiveness of the MMO, on UK energy market liquidity, and whether the intervention still benefitted consumers or could be improved upon.

Late in 2019, Ofgem announced it would be suspending the MMO as its assessments had identified that remaining participants were facing 'increased and disproportionate' costs. The MMO was officially suspended by Ofgem on 18th November 2019.

The resulting effect on liquidity

The effect of suspending the MMO will only be fully clear when enough data is available to make a proper assessment.

Using the fore mentioned indicators, Ofgem did assess liquidity for Q4 2019 and initial findings were released in early 2020. The bid/offer spreads did in fact widen, an indicator of reduced liquidity. The average churn rate of target products declined during the quarter.

Although, the churn ratio increased for December 2019, when compared with the 2 years prior. The reason for the decline in the churn ratio is linked with a reduction in traded volumes for December 2019, particularly on peakload products. Finally, times of trades remained concentrated between 1100 and 1600, however, to a lesser extent than in 2018.

Overall, Ofgem's initial findings showed liquidity 'did not significantly deteriorate' during Q4 19.

CHURN RATIO
The ratio between the number of transactions to physical demand

What is next and what does this mean for UK wholesale energy markets?

Ofgem began consultations on liquidity policy options with stakeholders in October 2019. Overall, participants opposed a re-designed of the obligation style approach and instead indicated that a tendered market-making approach would be fairer and would likely lead to more significant market changes. Market-makers act as wholesalers by both buying and selling to satisfy the market. How such an approach would be applied in practice is currently under review and findings are yet to be released.

In conclusion, liquidity must increase on UK Energy Markets to encourage market entry, increase competition and efficiency, and for the market to provide accurate signals for investment. Increasing liquidity on wholesale energy markets will remain a key focus for Ofgem over the coming years. Liquidity on far-curve products could become a key concern as the UK's energy infrastructure changes. As we move further away from a centralised baseload model and more towards local, renewable generation based around smart grids, it is likely liquidity of far-curve products will decline.

If you have any questions, please do not hesitate to contact your account manager, or call us on 01253 209000.

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