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POWER MARKET LIQUIDITY – COME BACK ENERGY MERCHANT BANKERS, ALL IS FORGIVEN

As far as market efficiency is concerned, perhaps energy users should be missing the energy merchants more than many actually are?

These banks have played their part in providing market liquidity. The annual wholesale prices quoted out on the curve represent 'bell weather' markers for industrial buyers to assess where the market is at any one time: forward traded over-the-counter contracts devoid of seasonal effects and actively traded.

Manipulate this market or (more to the point) allow this market to become so illiquid that it essentially manipulates itself - by sending distorted incentives to traders, making the curve even more illiquid - and opaque pricing will set in very soon, replacing efficient supply and demand reflective pricing that their presence in the market hitherto offered. This also leads to greater volatility and high risk-premia which are embedded into the price of PPAs. The same market distortions meanwhile can undermine market liquidity further, leading to further market exit and the cycle then becomes self-reinforcing.

This is the main reason why the exit of many investment banks is not good news for utilities, industrial buyers or households even. Both European level and national level legislation has piled layer upon layer of compliance cost onto the energy trading desks across the merchant banking industry. That extra burden, coupled with (certainly until very recently) low oil prices has rendered many energy trading desks at financial institutions 'non-commercial' in the eyes of internal restructurers.

Consequently, the banks concerned have quietly wound down or withdrawn their energy trading operations altogether, and with it the liquidity-providing role they had to play. To be fair, no single piece of legislation, European or national, is solely blame. However, EMIR, the EU European Market Infrastructure Regulation (which covers all and very broadly-defined over the counter trades and considers all of them as derivative contracts) can arguably claim to be the archetypal 'straw that broke the camel's back'.

In theory, EU Regulation No 648/2012 should have enhanced stability, transparency and efficiency in the forward gas and electricity purchasing (in EU eyes: 'derivative') markets.
Although the new cost burdens which EMIR has imposed on the banks (and the utilities too) has ultimately lead to a significant reduction in long-dating trading by the energy merchants, merchant banks and some of the major utilities too. It has caused liquidity to contract which may paradoxically have led to a market efficiency situation in energy which is precisely the opposite of what - for all its good intentions - EMIR had set out to avoid.

Prospect Advisory Ltd | www.prospectadvisory.co.uk | info@prospectadvisory.co.uk
+44 (0)20 3427 5955
Prospect Advisory Ltd is registered in England and Wales at Companies House under Company Registration Number 7566803.
Registered Office: Regus House Herald Way Pegasus Business Park, Castle Donington Derbyshire DE74 2TZ

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The finer details of EMIR and other primary legislation including the EU Market in Financial Instruments Directives (MiFID I and MiFiD 2) are too wide and complex to condense into one short article. However, the 'de facto' prohibition of cross-commodity clearing is widely recognised as having curtailed the commercial viability of forward gas and power trading operations within financial institutions. For example, merchant banks can no longer benefit from the operational efficiencies they once enjoyed by way of cross-netting positions across different commodities desks funnelled through a single account, with profits and losses pooled and efficiently offset against one another. That practice also bestowed significant economies of scale to the wider banking operation across all commodities and traded derivatives. So, whereas before, a merchant bank could centralise and net-out trades across, say, natural gas, gold bullion, Forex or interest-rate swaps through one internally-offsetting account, they are now required to operate separate trading desks each with separate books, reporting and accountability in order to meet EMIR's technical standards regarding the format and frequency of trade reports to trade repositories.

In the aftermath of the financial crisis (which hasn't necessarily gone away anyway) it was generally accepted that stringent EU legislation was required and more circumspect policing required for trading managers and - key here - the individual traders reporting to them. All this extra regulation - 'not before time' some might say - sounds all well and good. But in terms of effect, its long-term impact on liquidity and forward gas and electricity prices may be negative for UK energy buyers. So, has the EU "thrown the baby out with the bathwater" or not?

We can't answer this yet. So let's simply fast-forward to the market today. Calendar gas and power prices have risen roughly 20% over the past three months alone. The higher prices and notably higher market volatility will undoubtedly drive up renewal prices for industrial gas and electricity buyers as the April 17 round approaches.

To be fair though, there are underlying supply-and-demand factors that would at least partially explain the price rises witnessed in recent weeks. And given the spectacular power price gyrations we've seen very recently on Elexon for example - one could equally make the case that the Forward Curve hasn't moved more than could have, if the forward market was supposed to be this inefficient and jumpy.

But as fellow former traders will testify, never be fooled by a headline price. The screen just gives you the cost - not the volume or intent actually behind it. The forward prices can change significantly in the blink of an eye, especially once any 'feeler prices' or 'phantom trades' have been posted or executed.

But the main conclusion must be that no person, no formula, and no machine can actually say 'what would have been': how the market would have turned out had EMIR, MiFID and other legislation not been introduced. The jury is - and is likely to remain - still out on this chestnut. But even so and perhaps above all, it is hard to see how the exit of merchant banks and other players who bring liquidity and competition to the wholesale market will help the interests of energy utilities or end-consumers in the long term. Indeed the only winners here may turn out to be the incumbents and large players who are still in the market, now each with a greater slice of the marketplace to themselves. The effect is hard to ascertain just now although a shock of cold weather or supply disruption could yet give us an inkling of what to expect.

Prospect Law and Prospect Advisory provide legal and business consultancy services for clients involved in the infrastructure, energy and financial sectors.

Dominic Whittome is a private consultant and a former utility trading manager who has worked in the oil, gas and electricity trading market since 1990.

For more information please contact us on 020 3427 5955 or by email on: info@prospectadvisory.co.uk.