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Energy Cost Management Solutions

Energy Comment

New initiatives in the UK wholesale market

Scottish and Southern Energy (SSE) have moved to shake up the UK wholesale electricity market by announcing that they intend to purchase all of its power for retail customers on the day-ahead market. They have also said that they will auction their generated supply into the same day-ahead market place.

SSE is the UK's second largest electricity generator with around 15% (47,500 GW) of the total UK market. SSE's average daily demand volume is around 165GWh. Given the total size of the UK day-ahead market – 240GWh – then this announcement is, on the surface of it, transformational.

SSE hopes to be trading around 25% of its supply and demand on the DA market by end Nov. The Group has also said that it intends to move completely over to the day-ahead wholesale market at the end of its financial year in March, 2012.

The move is seen as SSE being the first supplier to respond to Ofgem's well publicised view that there is insufficient liquidity in the GB wholesale energy markets as a whole. It's also seen as being partly politically motivated, with much sabre rattling around **energy companies being 'forced' to auction all of their electricity on the open market.**

As always in these announcements, however, the devil is in the detail. Whilst any move to increase volume flows and activity within the energy market is to be welcomed, it should not be seen as being a pre-cursor to a new regime of lower prices for all.

This is all about liquidity, or rather the lack of it that we have seen in the UK wholesale energy markets up to now, and how these series of proposed actions by SSE will improve liquidity at the short end of the market. As liquidity improves – i.e. there are more trades and greater volumes transacted, then that leads to better price transparency and improved price discovery. You then get a 'snowball ' effect - better price transparency and improved price discovery makes it easier for more participants to enter the market. The more players you get in the market, the greater the competition, the keener the pricing – i.e. bid / offer spreads and margins improve.

Longer term this increase in activity and competition should drive prices down but it's wrong to assume that there is a causal link between the two and that greater liquidity necessarily equates to lower prices across the entire price curve.

It's important to note that SSE's decision applies only to the day- ahead market. The forward market will continue to operate in exactly the same way as it operates now, with generators and suppliers forward purchasing up to 24 months ahead to enable them to offer fixed rate contracts to customers and lock in profit margins.

Whilst SSE's move may well push the other major players to become more involved in the day - ahead market, it seems unlikely that any additional effect will be felt further out on the energy curve, either in terms of increased competition or increased liquidity. As long as that situation persists, supply demand fundamentals will continue to be the key drivers in longer term pricing.

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