

Liquidity Providers in European Gas Markets

Introduction

Liquid and transparent wholesale energy markets help bring benefits to consumers and provide at the same time the right investment signals to enable efficient delivery of secure energy supplies. Although progress has been made, the practical implementation of an internal European gas market is still behind the expectations of market participants.

EFET has previously pointed out the need for better access to infrastructure (capacity), this short note suggests how the equally important issue of access to tradable gas (commodity and flexibility) can be moved forward at Europe's developing gas hubs.

EFET believes that market liquidity would increase significantly if gas and capacity were made available in conjunction with the introduction of liquidity providers.

Liquidity providers

Improvements are urgently needed to enhance liquidity on several emerging continental gas hubs. In a liquid market¹ it would be possible not only to trade substantial volumes of gas, but also to do so without significantly moving the price.

A liquidity provider is a person or firm (incumbent, exchange or market participant) who quotes a buy and sell price in a financial instrument or commodity hoping to make a profit on the turn or bid/offer spread.

In a well-established market any participant might choose to be a liquidity provider, but in a developing market the company best placed to make a commitment to provide liquidity will be the company that controls the largest portion of gas in the relevant area.

Liquidity provision can complement a gas release programme

Europe's Gas Release Programmes (GRPs) have had varying success, with recent GRPs failing to translate into significant liquidity improvement, for example there is very little re-trading of release volumes in France or Germany.

¹ See page 64 of the EFET publication "The Past and future of European Energy Trading" June 2005

Part of the problem has been that access to local transmission capacity has been uncertain, and gas has tended to flow away from the release location into a neighbouring country with better liquidity.

Equally important, however, has been the inherent lack of liquidity in the country where the gas release has taken place. The presence of liquidity providers at a hub associated with the release programme² would enhance the micro-structure of this market and translate into deeper liquidity. Another way to consider this is that the GRP provides bulk gas commodity and the liquid trading hub provides the flexibility to adjust the release gas portfolio and manage risk.

Some practical considerations & what liquidity providers do

Gas trading is at different stages of development across Europe, ranging from a well established futures market at the NBP in the UK through to countries mainly in the east of Europe where trading has not yet begun

In a developing or established traded market a liquidity provider would be expected to:

1. Make a two way market (a bid and an offer) for a standardised size
2. Provide tight market spreads (the tightness depending on market conditions)
3. Provide liquidity on a number of products such as day ahead, weekend or front month markets.

Where a dominant player is concerned that their participation in the market might give rise to regulatory or competition concerns then it may be that undertakings on the behaviour of the company will need to be made to the relevant authority. From a market perspective when a dominant company is involved the key is that there is a commitment to a consistent and continuous approach to liquidity provision, and transparency about any material change, termination or extension of any arrangement.

Liquidity provision in NW continental Europe

The role of the liquidity provider envisaged above fits well where trading hubs have been created or release programmes attempted but actual trading is still in its early stages of development or confidence in the market is lacking. There are welcome signs that greater participation is emerging and EFET offers to work with the companies involved to help their involvement lead to the liquidity that the market needs. Gas volumes that liquidity providers are willing to make available will need to grow as a percentage of the market until liquidity is self-sustaining.

² i.e. either the release takes place at the hub or there is guaranteed capacity between the point where the release takes place and the hub where the liquidity provider operates

There is no doubt that liquidity at the hubs throughout NW Europe would be enhanced through participation of major players as liquidity providers in their home markets. The depth of the market, however, will still depend on the willingness of parties to actively trade the market. For example, a high transaction cost or lack of volume on offer could hamper their efforts.

There is also an important role for TSOs, who could also enhance liquidity if they were obliged to balance their grid by entering into spot trades with other shipper/traders in the grid. This is currently the case for NationalGrid in the UK and is planned for France and the Netherlands. This system invites the traders to provide bids and offers for spot products that the TSO might need to buy or sell, so it naturally stimulates liquidity.

Market-based balancing will encourage liquidity

Even without an undertaking from a particular company or a regulatory requirement on a TSO to provide liquidity, the simple design of a within-day balancing regime with a cash-out market related mechanism, should attract liquidity from market participants. Provided that there are not other barriers to trading in the balancing region, the participants will trust that they can always find a buyer or a seller, or sufficient flexibility to either physically exit their position or cash it out at a market related cost.

This virtuous circle initiated on the very prompt physical market has proven to spread trust, and therefore liquidity, further to the forward traded contracts.

Liquidity provision as a transitional measure

Whilst some companies may identify commercial opportunities and choose to be liquidity providers in fully traded markets, it may be advantageous for liquidity provision to take place without immediate commercial gain in the transition to a fully competitive market.

During the development of the UK gas market in the late 1990s there were, for example, undertakings made by British Gas during a transitional phase toward the On-the-day Commodity Market. The undertaking was that British Gas would guarantee to place in the market all the upward and downwards flexibility from the larger part of its long term contract portfolio. Every day-ahead this upwards and downwards flexibility was put in to the Flexibility Mechanism at a price that could be chosen by British Gas but within a limited bid-offer spread that had been agreed with the Regulator.

The most appropriate transitional undertakings to provide liquidity will need to be adapted to the local circumstances, but in all cases where the majority of the gas in an area is under the control of one company it is likely that some action will be necessary to enable the market to develop. The best solutions are likely to be found when the company concerned is proactive rather than waiting for regulatory intervention.

