Commentary on Electricity Futures Prices

Greg Sise
Energy Link Ltd

9th April 2014

Plan your energy decisions with confidence

Energy Link
DECISION POWER

Futures Prices and Spot Prices

1. In theory, futures prices reflect expected spot prices
2. In practice, futures prices tend to sit above spot prices:
    1. rises in Q1 prices with low inflows often occur along with, or shortly before, movements in Q2, Q3 prices and sometimes further out in the future: this seems odd to us, as inflows do not correlate to that extent
    2. Energy Link forecasts significantly outperform the futures market at predicting spot prices
    3. movements in futures prices auto-correlate to a significantly higher degree than historical spot prices (17 inflow years) & forecasts (83 years)
3. The positive premium relative to expected spot price is around 10% on an annual basis, higher in Q2 & Q3
4. Is this new? Yes – evidence for premium being consistently positive (OTC also) since 2011
5. Is this a risk premium? Possibly - it does appear to vary with season, but is also quite large for a risk premium
6. Is it something else? Possibly – the futures market may be signalling LRMC instead of SRMC
7. Retailers & consumers don't want to contract long in a weak market, generators do. So an imbalance in demand should see lower premiums further out to attract buyers. How reliant are generators on the futures market?
8. Is it a bad thing? Do market-makers often undercut futures prices in the OTC market? Evidence?
9. Are speculators interested? Underlying problem is low liquidity in later quarters – not enough traders to trade the premiums away. Those that are interested may be put off by higher liquidity risk and high initial margins.
10. Can it be changed? History suggests this won't be easy.
    1. Consider a reduction in contract size to as little as 0.1 MW – reduces liquidity risk and initial margins
    2. Narrowing the bid-ask spread might help
    3. More skin in the game - mandate minimum hedge volumes through the futures market (unintended consequences?)
    4. Front quarters are OK, so focus on mid quarters first, then work further out the curve

Energy Link
DECISION POWER