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Other Interested Parties

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Date: 23 January 2014

Dear Colleague

### **Wholesale power market liquidity: decision letter**

On 20 November 2013, Ofgem published "Wholesale power market liquidity: statutory consultation on the 'Secure and Promote' licence condition" (the Statutory Consultation)<sup>1</sup>, alongside a draft guidance document<sup>2</sup> and an impact assessment<sup>3</sup>. The Statutory Consultation set out our final policy position proposing the introduction of a new special licence condition into the generation licences held by eight company groups. It also set out the proposed text of the licence condition, stating that, subject to responses, we intended for the condition to take effect from 31 March 2014. We received 19 responses to the consultation, which closed on 18 December 2013. All non-confidential responses have been placed on the Ofgem website.<sup>4</sup>

In this letter we set out our decision, following consideration of these responses, to direct changes to the generation licences held by the eight company groups and to implement in full our final policy position.

The responses to our Statutory Consultation raised issues for our consideration in respect of our overall policy approach, the parties to which the proposed special condition should apply both now and in the future, and to specific aspects of our Supplier Market Access rules, Market Making obligation and reporting requirements. We summarise and address these issues below. Respondents also raised points in relation to our draft guidance document and impact assessment which we address in annexes to this letter. We are grateful to respondents for drawing these issues to our attention.

### **Points raised in response to the Statutory Consultation**

In response to points raised by respondents, we have made changes to the licence text to amend minor typographical errors and to clarify drafting to more accurately reflect the policy intent set out in the Statutory Consultation. We have not made any change that

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<sup>1</sup> <https://www.ofgem.gov.uk/ofgem-publications/84508/wholesalepowermarketliquiditystatutoryconsultationonthesecureandpromotelicencecondition.pdf>

<sup>2</sup> <https://www.ofgem.gov.uk/ofgem-publications/84510/draftguidance-liquidityinthewholesaleelectricitymarketspecialconditionaoftheelectricitygenerationlicence.pdf>

<sup>3</sup> <https://www.ofgem.gov.uk/ofgem-publications/84511/impactassessment-wholesalepowermarketliquidity-statutoryconsultationonthesecureandpromotelicencecondition.pdf>

<sup>4</sup> <https://www.ofgem.gov.uk/publications-and-updates/wholesale-power-market-liquidity-statutory-consultation-secure-and-promote-licence-condition>

alters the policy intent set out in our Statutory Consultation. The changes made can be found as tracked changes in Schedule 2 of the Decision Notice.<sup>5</sup>

Respondents also raised points in relation to the impact assessment and draft guidance document. These points are summarised and addressed in Annexes A and B to this letter. Stakeholders should note that today we have also published an updated guidance document which incorporates some additional points of guidance requested by respondents.<sup>6</sup>

Finally, respondents raised a number of general points, largely in relation to our policy, and these are addressed below.

### Alternative intervention options

Four respondents suggested that we should consider the merits of an alternative policy approach, specifically a Self-Supply Restriction (SSR), although some of these respondents did note that they considered our proposals would have a positive impact on liquidity. One respondent suggested that we should implement business separation, a prohibition on cross-subsidy, and a non-discrimination condition.

We have already undertaken a very extensive policy consultation process over an extended period of time, during which we have consulted widely on a variety of options to address the lack of liquidity in GB wholesale power markets. The options we have considered have included a form of SSR. We decided not to proceed with a SSR for a number of reasons<sup>7</sup>, principally because it would fall short of meeting our liquidity objectives. It would not ensure an increase in liquidity along the curve because there is no guarantee that opportunities to trade in forward products would be created, and it would not ensure that smaller players could sign trading agreements or get access to the products they need (such as small volumes of energy). Our policy view is that the proposals we have put forward best meet our stated objectives for improving liquidity.

### Implementation date

Two respondents asked us to postpone our proposed implementation date of 31 March 2014 to allow additional preparation time. We have been clear about our timetable since our consultation in December 2012. Our final proposals document in June 2013 stated our intention to have arrangements in place in the first quarter of 2014, and we clarified the exact date that they should take effect in our Statutory Consultation in November 2013. We consider that stakeholders have been given ample notice both of the nature of the arrangements we are putting in place and the timescales that we have been working to. Therefore, we do not intend to postpone the implementation date.

### Licensees to whom this obligation applies

One respondent argued that the choice of licensees to whom the obligation applies is discriminatory. A small number of respondents argued that there should be firm thresholds at which the licence obligations apply, either set out in the licence condition or in the accompanying guidance document. One respondent suggested that the obligations might be considered a Public Service Obligation under Directive 2009/72/EC (commonly referred to as the Electricity Directive)<sup>8</sup>. Another respondent questioned whether the policy might be deemed State Aid.

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<sup>5</sup> Available at the following page on the Ofgem website:

<https://www.ofgem.gov.uk/publications-and-updates/wholesale-power-market-liquidity-decision-letter>

<sup>6</sup> Available at the following page on the Ofgem website:

<https://www.ofgem.gov.uk/publications-and-updates/wholesale-power-market-liquidity-decision-letter>

<sup>7</sup> This was discussed in Appendix 2 of the draft Impact Assessment: <https://www.ofgem.gov.uk/ofgem-publications/39303/liquiditydraftia120613.pdf>

<sup>8</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0055:0093:EN:PDF>

We set out our rationale for applying the licence condition to certain company groups in our Final Proposals consultation<sup>9</sup> in July 2013. We explained the factors that we had considered which included the structure of the generation and supply markets; the key players in the market; licensees' capability to meet the obligations at proportionate cost and risk; and the need to ensure that the intervention is effective. We set out our analysis that underpinned our rationale for deciding which company groups should face each part of the obligation. We remain satisfied that the choice of licensees is appropriate.

We set out our reasons for not using thresholds in our Statutory Consultation. We noted that mechanistic thresholds would be unlikely to improve the effectiveness of the intervention; might impose unnecessary costs on the industry (for example, through drawing in more parties to the obligation than would be necessary to meet our liquidity objectives); and could give rise to perverse incentives where licensees came close to meeting any pre-determined threshold. We continue to consider that the risks and unintended consequences of having thresholds outweigh any benefits.

We do not consider that any part of the licence condition amounts to a Public Service Obligation. Having considered our policy design against the test for State Aid<sup>10</sup> we do not consider that any part of the licence condition would constitute State Aid.

#### European financial legislation

A small number of respondents repeated their concerns that our policy could increase the risk that affected licensees might be exposed to European financial legislation, in particular the revised Markets in Financial Instruments Directive (MiFID II).

In our Statutory Consultation we stated that we intend to carry out a review before MiFID II is implemented in GB. We noted that we would focus particularly on whether revisions to European financial legislation had created any disproportionate changes to the costs faced by licensees subject to the Market Making obligation. We also noted that we would consult with stakeholders. As further mitigation, the licence condition also allows a licensee to submit to us a (non-binding) request for a review. Further, the licence condition allows licensees to nominate a third party to deliver their Market Making obligation; the third party could already be within the scope of European financial legislation and therefore unaffected by any changes. We therefore consider that we have taken appropriate steps to address concerns that our policy might expose licensees to disproportionate costs arising from European financial legislation.

#### Application of the obligation to company groups

A couple of respondents thought that the licence drafting could force each licensee within a group to carry out the obligations separately. They noted that this was contrary to the statement in the draft guidance that the obligation only needed to be met once per group. One respondent suggested that this made the obligation unaffordable.

As set out in our Statutory Consultation and final proposals consultation, the intention is for the obligations to apply only once to each company group. We have adjusted drafting in the licence condition to ensure that this is clear.

#### Issues raised in relation to specific elements of the policy design

A range of respondents raised points in relation to specific elements of the final policy design and the impact that these would be likely to have on liquidity.<sup>11</sup> We considered carefully all the feedback that we received from respondents. Some comments suggested changes to the licence condition; we have not included any changes which would alter the

<sup>9</sup> <https://www.ofgem.gov.uk/ofgem-publications/39302/liquidity-final-proposals-120613.pdf>

<sup>10</sup> [http://ec.europa.eu/competition/state\\_aid/legislation/compilation/state\\_aid\\_15\\_11\\_13\\_en.pdf](http://ec.europa.eu/competition/state_aid/legislation/compilation/state_aid_15_11_13_en.pdf)

<sup>11</sup> These points do not suggest changes to the Guidance document (addressed in Annex B to this letter).

policy design set out in the Statutory Consultation. Among changes suggested to the licence text were framing the obligations in terms of “all reasonable steps”, ensuring that licensees could recover all costs of the obligations, and changes to the timing of the first trading window.

Two respondents expressed the view that including a volume cap in the Market Making obligation constituted a watering down of the proposals and consequently only a small volume of power would be traded. A few respondents argued that widening the spreads for baseload products would limit the impact of the reforms, while another argued that our proposed spreads were wider than those at current levels. A small number of respondents suggested the introduction of trading windows would similarly limit the impact of the reforms. A number of respondents suggested that additional products should be included within the obligation.

In respect of the volume cap, we disagree that this will lead to only a small amount of volume being traded. The cap is intended as a backstop provision and we envisage that it would be utilised very rarely. The cap is net rather than gross and applies per market maker, per product, per trading window. With six market makers, this means that each of the 13 available products has a net cap of 180MW<sup>12</sup> in each of the 2 daily trading windows. As the cap is net rather than gross, the actual volume of trading that could occur before the cap is breached is likely to be significantly higher.

In respect of spreads we note that aside from the month+1 baseload product we have not seen evidence to support the case that the spreads proposed are tighter than those currently seen. We noted when we revised our proposed spreads that one factor we were taking into account was that the market spread would usually be tighter than the levels we set for individual market makers. We consider that the spreads set out will provide significantly improved opportunities to trade, particularly for the products that are currently least liquid.

In respect of trading windows, in our Statutory Consultation we noted that trading windows offered a number of key advantages including guaranteeing opportunities to trade at known times twice every day with all the market makers. Rather than limit the reforms, we consider that trading windows provide a twice daily focal point and can provide a basis for the further development of trading.

In respect of including additional products within the obligation, we noted in our Statutory Consultation that we had given consideration to this point. The policy intention is to strike a balance between the needs of independent suppliers and the overall costs of delivering the obligation. We do not consider that the case has been made for an increase in the granularity of available products.

With all parts of the policy design, we will be monitoring progress and assessing effectiveness on an annual basis.

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<sup>12</sup> Note that the cap is expressed as a capacity figure (MW) rather than output (MWh) as output levels differ for each product. The output for a season long product would be around 26 times greater than for a week long product. Annual consumption of power is in the region of 320TWh. If every volume cap was reached in a year, the volume would be around 2460TWh – or over seven times the amount of electricity consumed in GB annually.

## Licences that we have decided not to modify

In Schedule 1 to Appendix 2 of the Statutory Consultation ("notice under section 11A(2) of the Electricity Act 1989") we published a list of licences that we intended to modify. We received notification from affected parties that three of the licences listed should not be subject to the licence condition. Having considered the representations, we agree that the following licences are not controlled<sup>13</sup> by the company groups which we intend this licence condition to apply to. We have therefore decided not to modify the following licences:

- Sutton Bridge Power Limited
- Galloper Wind Farm Limited
- Greater Gabbard Offshore Wind Farm Limited

## Decision

After considering the responses to our Statutory Consultation we consider it remains appropriate to direct the licence modifications to be made in line with those proposed.<sup>14</sup> This is set out in the Decision Notice published alongside this letter.

## Next Steps

Following the publication of the Decision Notice today, any relevant party that wishes to appeal the Authority's decision to the Competition Commission may do so on or before 20 February 2014.

If no successful appeal is forthcoming, this licence condition will be inserted into licences on 21 March 2014 (being 56 days after the decision to modify), but will not become active immediately.

On or after 21 March 2014 the Authority will issue two directions:

- One of these directions will apply to the six company groups required to meet all the requirements of the condition. This will relate to paragraph AA.2 and will switch on the licence condition on 31 March 2014.
- The second of these directions will apply to the licences held by Drax and GDF Suez. In addition to switching on the licence condition as above, these directions will at the same time activate paragraph AA.3, meaning that these two company groups only need to comply with Schedules A and C of the special condition.

Should you wish to discuss any aspect of the Secure and Promote policy please contact Graham Knowles ([wholesale.marketoperation@ofgem.gov.uk](mailto:wholesale.marketoperation@ofgem.gov.uk)).

Yours faithfully,

Joanna Whittington  
Partner, Wholesale Market Performance

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<sup>13</sup> The licensees are not affiliates of the company groups as defined in Standard Licence Condition 1 of the Electricity Generation licence.

<sup>14</sup> As reflected in Schedule 2 in the Decision Notice, we have made a number of changes to amend typographical errors or to clarify drafting to better reflect our policy intention.

## **ANNEX A – Summary of responses to Impact Assessment**

This annex summarises the feedback from stakeholders to our Impact Assessment (IA) published alongside the Statutory Consultation.<sup>15</sup> In some places we also include our views on the points raised.

We received four responses: three from Secure and Promote (S&P) licensees, and one from an independent supplier.<sup>16</sup> All responses were non-confidential, and have been placed on the Ofgem website. For this reason, we do not repeat every point in this annex, focussing instead on the main issues raised.

### **Question 1: Do you agree with our description of the key issues and objectives for our Secure and Promote proposals?**

- Respondents agreed with our description of the key issues and objectives. One respondent did note that churn remained unchanged in 2013 and that bid-offer spreads had tightened.

### **Question 2: Do you agree with our evaluation of the impact of our Secure and Promote proposals on consumers?**

- Respondents partly supported our evaluation of the impact on consumers. For example, one respondent agreed that increased competition could encourage suppliers to improve efficiency and to innovate.
- Respondents said that consumers could potentially face net costs from the intervention, if costs were higher or benefits were lower than expected.
- One respondent criticised the suggestion that costs could be passed on to consumers. It argued that this would not be possible if all firms in the market did not face the same costs. We concentrated on consumers in this chapter, meaning that it was correct to evaluate what would happen if they ended up paying some or all of the costs of S&P. This is different from assuming that S&P licensees will necessarily be able to pass on any particular costs.

### **Question 3: Do you agree with our evaluation of the impact of our Secure and Promote proposals on competition?**

- One respondent agreed with our evaluation, arguing that low liquidity is creating a barrier to entry and limiting competition by non-vertically integrated suppliers.
- One respondent agreed that the Supplier Market Access (SMA) rules would help to address the needs of small suppliers, building on existing industry commitments. Another firm agreed with the objective of the SMA rules, but disagreed with the selection of obligated firms.
- One respondent stated that the design of the market making obligation was a new feature not previously seen in comparable markets. This respondent did support our position that there are benefits from maintaining competition between trading platforms.
- Two respondents highlighted our statement that "S&P licensees will incur costs which their competitors will avoid". Both suggested that we had underplayed the potential impact on the relative competitiveness of firms with and without the obligation. One respondent thought that we had also underplayed the impact on the

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<sup>15</sup> Ofgem (2013), 'Wholesale power market liquidity: statutory consultation on the 'Secure and Promote' licence condition – Impact Assessment', 20 November 2013.

<sup>16</sup> One other firm mentioned the IA as part of its response to the Statutory Consultation, stating that it agreed with the approach and evaluation.

relative competitiveness of S&P licensees, as a result of firms of different sizes facing the same obligation.

**Question 4: Do you agree with our evaluation of the impact of our Secure and Promote proposals on sustainable development?**

- Respondents generally agreed with our comments on sustainable development, concentrating on the impact on the reference price for the baseload Contract for Difference.

**Question 5: Do you agree with our evaluation of the cost impacts of our Secure and Promote proposals?**

- One respondent thought that the cost estimates were roughly correct.<sup>17</sup> Another respondent agreed with the figures for the SMA rules, stating that its estimates were within the range presented in the IA.
- However, two respondents disagreed in relation to market making, reiterating messages from their responses to the draft IA that costs would be several times higher.<sup>18</sup> This was primarily in relation to the ongoing costs.<sup>19</sup> When preparing the IA, we carefully considered all the responses received to the previous consultation. We recognise that others may have different views on the assumptions used, but we remain confident that the estimates proposed are appropriate, and have not received any new evidence that would cause us to reassess this view.
- One respondent set out a list of factors which it believed will increase price volatility, which could raise costs for S&P licensees. These factors seem plausible, but, as noted by the respondent, their direct impact would be on the near-term markets; the impact on the forward products included in the market making obligation may be less significant.
- Another respondent suggested that the IA estimates the benefits of “introducing competition”, and that it is based on a “monopoly structure”. This is a misreading of our position; we do not consider these points to be valid.
- This respondent also stated that we are seeking to impose regulation of profits. This is not our intention. References to profits were merely to indicate a potential way in which increased competition could deliver benefits, and to show that the reduction in profits required to cover the costs of S&P is relatively small.

**Question 6: Do you agree with our evaluation of the risks and unintended consequences of our Secure and Promote proposals?**

- One respondent did not think that the potential risks to the effectiveness of the SMA rules would materialise.
- Respondents expressed differing views on the risk that market making would have a limited effect on traded volumes. One respondent agreed with our position that this would not be a problem, but another respondent suggested that large volumes would be needed to offset the fixed costs of market making.
- Respondents also provided contrasting opinions on the risk of decreasing liquidity outside trading windows. One respondent thought that this was a significant risk, whereas another respondent did not consider this to be a concern.

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<sup>17</sup> Provided the obligation only had to be met once by each group.

<sup>18</sup> One respondent did note that design changes since the publication of the draft IA had reduced its cost estimate, but that this remained above the estimate we presented.

<sup>19</sup> One respondent also thought that the set-up costs of market making would be above our high case estimate.

- Regarding the risk of distortions to the market price, one respondent argued that the bid-offer spreads might not allow market makers to reflect their view of market conditions. We note that we have introduced a fast market rule, which would allow market makers to stop posting prices in extremely volatile conditions.
- One respondent thought that the liquidity intervention created “significant regulatory risk” and that this could affect investment in generation. We have consulted several times and listened to feedback from stakeholders – this should reassure investors that regulatory decisions are taken with due care. Any regulatory risk should also be reduced by our commitment to leave S&P for at least three years before considering major changes, and by the fact that any change would follow the usual consultation process, with opportunity for appeal.
- One respondent emphasised the compliance risk for S&P licensees, saying that “accidental breaches of the licence condition will be inevitable”. We set out in our guidance document our approach to enforcement.

### **Other comments**

- One respondent noted that none of its generation licensees hold a domestic supply licence, and therefore disagreed with the characterisation of its business as vertically integrated in our June 2013 consultation document. As indicated later by the respondent, our assessment is based on overall corporate groups, rather than the particular structure of licences within those groups.
- This respondent also suggested that other licence conditions prevent it from offering “preferential arrangements” when trading with supply businesses in its group. We would like to state that our analysis does not depend on the existence of such arrangements.



## **Annex B – Responses to “Liquidity in the Wholesale Electricity Market (Special Condition AA of the electricity generation licence): Draft Guidance”**

A number of respondents commented on aspects of our draft guidance document. In addition a number of detailed points raised in respect of the draft licence text have given rise to some further clarifications in the final version of the guidance document. This annex discusses the main points raised and changes made in relation to the guidance.

### **Chapter one – Secure and Promote: overall legal structure**

- Comments on this chapter focussed on the criteria for amending the set of S&P licensees. Several firms asked for the use of specific thresholds. As set out in paragraph 2.6 of the Statutory Consultation, we think that the selection of S&P licensees should be based on a range of factors taken together, rather than a single threshold figure. Various other firms also asked for additional detail to be included in the guidance. Having considered these responses, we have not identified any changes which we consider would improve the clarity of the guidance while preserving the policy intent.
- One respondent also questioned the use of the word “normally” to describe our approach to removing the S&P licence condition on the sale of a specific asset (and associated licence). We have amended the wording slightly to clarify that we will remove the condition apart from in very exceptional circumstances.
- One respondent sought clarity on the role of paragraph AA.3. We have clarified that this is the switch designed to deliver the policy intention that certain S&P licensees are subject to Schedules A and C only.
- Another respondent wanted assurances about future changes to the licence condition. As noted in paragraph 1.6 of the draft guidance, any changes to the licence condition would follow the usual statutory consultation process.

### **Chapter two – Supplier Market Access rules**

- A couple of respondents asked whether it would be possible to use a generic e-mail address to meet the named contact requirement. We have clarified that this is acceptable, but that the licensee must also provide the name of at least one staff member.
- One respondent asked us to provide additional detail about what would be considered legitimate reasons not to trade with a small supplier. As stated in the draft guidance, this could be a result of a small supplier failing compliance checks. We also note that we expect licensees to have due regard to other legislation.
- This respondent also wanted a definition of an objectively justifiable risk premium for trading small clip sizes. We consider that this is adequately clarified by the term used – a licensee that applies such a risk premium must be able to justify this to us.
- In response to feedback, we have clarified that the requirements to provide a quote do not apply if an Eligible Supplier is in breach of its trading agreement.
- We have also clarified that credit terms may change over time.
- We have also provided various minor points of clarification where sought by respondents, for example clarifying that acknowledgement of a request for a trading agreement does not have to be in writing.

### **Chapter three – Market making obligation**

- Several respondents noted that technical issues with trading platforms (eg tiny gaps between timestamps when changing prices) could create periods of apparent non-compliance. We have clarified that the obligation should be interpreted subject to the technical limitations of the trading platform. If we become aware that this position is being abused in any way (for example if technical arrangements for fulfilling this licence obligation are noticeably different compared with those for other trading activity), then we will seek to remove it.
- Respondents also sought clarification about the point at which the five minute reloading period starts. We already set out in paragraph 3.11 of the draft guidance that the reloading period starts at the point when a price is removed from the screen.
- Following feedback from a respondent, we have added additional clarification about the functioning of the fast market rule.
- We have also clarified that a licensee or Nominee may meet the requirement to have arrangements in place to trade the Products with at least five unrelated firms through an exchange.

### **Chapter four – Reporting requirements**

- In response to feedback, we have changed the licence wording to state that quarterly reports need to be “approved” rather than “signed” by a Director of the licensee.
- One respondent suggested that we should consider intraday markets as well when evaluating near-term markets. While there is no reporting requirement for the intraday market, the guidance already notes that firms may submit additional information to show how they are supporting effective near-term markets.

### **Chapter five – Becoming an ‘Eligible Supplier’ for the Supplier Market Access rules**

- One respondent noted that we will need to publish the list of Eligible Suppliers before S&P comes into force. We are aware of this – a list will be published before 31 March at the link set out in the guidance document.
- One respondent suggested that we should reduce the eligibility test from 5TWh supplied over the last 12 months to 1TWh, arguing that this would be more closely aligned with the threshold of 250,000 domestic customers used in other areas. We think that the 5TWh threshold is appropriate, when combined with the 0.5TWh limit on the volume that a licensee is required to trade with a particular Eligible Supplier. This design will help an Eligible Supplier to sign trading agreements with several counterparties.
- Another respondent thought that another eligibility requirement should be increased from 1TWh generated to 5TWh. We have been clear that the SMA rules are targeted at small suppliers, so we do not agree with this change.
- A couple of points were raised regarding the removal of firms from the list of Eligible Suppliers. We have clarified that when firms are removed from the list that this will apply immediately, and that in this case the requirements under Schedule A will no longer apply when dealing with this firm.