The voice of the energy industry

Energy UK response to the Ofgem Wholesale Power Market Liquidity: Final proposals for a 'Secure and Promote' Licence Condition consultation

9th August 2013

Liquidity Narrative

1. Introduction

Energy UK is the trade association for the energy industry. Energy UK has over 80 companies as members that together cover the broad range of energy providers and suppliers and include companies of all sizes working in all forms of gas and electricity supply and energy networks. Energy UK members generate more than 90% of UK electricity, provide light and heat to some 26 million homes.

Energy UK welcomes the opportunity to respond to Ofgem's final proposals for the "Secure and Promote" liquidity licence conditions. .

We considered all three Liquidity Licence Conditions as set out in Schedules A, B and C of the Ofgem "Wholesale Power Market Liquidity" consultation on proposals for a "Secure and Promote" licence condition" published on 12th June 2013.

In discussion with our members we concluded that the dialogue around the provisions within Liquidity Licence Conditions Schedule A: Supplier Market Access Rules should be conducted on a bilateral basis between Ofgem, obligated parties and suppliers. Schedule C; Reporting Requirements we believe should be developed with oversight by Ofgem, following decisions on the proposals for Market Making.

The focus of this paper is therefore to present a collective response to the Liquidity Licence Condition Schedule B: Market Making Obligation.

For the avoidance of doubt, the group has taken care at all times to ensure that it has not discussed any issues that are restricted on competition grounds.

2. Developing the response

To develop the Energy UK response to Schedule B: Market Making Obligation, Energy UK established a specialist working group, independently chaired by Neil O'Hara, Chief Executive of Eggborough Power. Participants in this working group were from Centrica, EDF Energy, E.ON UK, RWE npower, ScottishPower, SSE, Draxpower, InterGen, Good Energy, ESB and GdF Suez. Our wider membership has been updated, the Futures and Options

Association consulted, and the chairman of the Power Traders' Committee has participated as a member of the working group.

We have taken the opportunity to have two meetings with Ofgem and attended its liquidity roundtable. We would like to thank Ofgem for its accessibility.

This response provides a proposition developed by both obligated and non-obligated members as an effective and practical solution to the Schedule B: Market Making Obligation requirement.

It is not intended to necessarily present the preferred outcome of any one of the participants, all of whom are expected to be responding separately to Ofgem.

3. Objectives and key observations

The stated objectives of the Ofgem proposal are:

- to ensure that all parties have opportunities to trade in forward markets;
- to develop robust price signals along the curve; and
- to facilitate competition through entry of new players and between existing players.

The industry agrees with the objective of Ofgem to improve transparency and liquidity in the wholesale market. We would however note that this is possibly the first time that a licensee obligation for market making has been mandated in a liberalised market and as such it is difficult to foresee the outcome. Markets are not readily predictable and as a consequence close attention will need to be paid to how the market reacts, with a view to effecting early adjustments should this be required.

Ofgem will therefore need to consider carefully the balance between the degree of detail put into the licence obligation and that which is better placed in accompanying guidance, in order for it to retain the ability to act quickly should the outcome be less than optimal at the start or as the market develops.

Many of the issues to be considered are linked. For example the length of time that a market is available or open, is directly linked to other specifications such as the bid offer spread, transparency and liquidity.

This in turn means that a number of the proposals within the draft market making obligation should be viewed as a package and not separated out into discreet and separate issues for independent resolution.

Regulatory reporting requirements will be clearly necessary and where possible should mirror those that are likely to be introduced as a result of the EU Regulation on Wholesale Energy Markets Integration and Transparency (REMIT).

Should this not be possible, then the REMIT requirements need to be taken into account when designing the transaction reporting rules.

The implementation of the final decisions on the Market Making Obligation (whatever they may be) will be complex, interconnected and will take time to put in place. As such we would urge that this is an issue that needs to be considered early.

In order to avoid delay and the higher risk associated with a "big bang" implementation, it is considered preferable to have a phased process, with a roll out of incremental products as each phase is proven to be viable.

We would like to underscore that such a roll out is not and should not be considered as a delay mechanism. We propose this approach for the purposes of effecting a quick implementation with minimum disruption and maximising the chances of success.

There needs to be a clear set of criteria against which any roll out should be judged. Such criteria will need to be both objective and subjective and could include:-

- A market which is demonstrably more transparent and with improved price discovery;
- An increase in liquidity especially during the proposed trading windows;
- A market that gives confidence to both obligated and non-obligated participants;
- A market that can develop as third party requirements change;
- All Energy UK members consider that a fundamental principle for a sustainable and long-lived outcome is that the final solution on the requirements of the Market Making Obligation should not significantly disadvantage any one party.

4. Proposed market making obligations rules

Critical to meeting both the objectives of Ofgem and the industry will be the proposed market making obligation rules. In summary, our proposals for the rules are set out below:-

i. *Phasing in the changes* – Overall, our members have set out as a preference that the introduction of the requirements should be phased over a period of time to enable the process to bed down. We envisage that Phase 1 would commence three months after the licence condition has been introduced and Phase 2 six months after the licence condition has been introduced. Such a period of time keeps the impetus on a steady roll out whilst providing time for the market to settle and for any issues that may arise to be assessed and resolved.

ii. *Nominating a third party as a market maker* – At the commencement it is anticipated that the six obligated parties will make choices resulting in between three and six undertaking market making activity. We note in the Ofgem proposals that it is allowable for an obligated party to outsource its market making activity to another obligated firm.

   Furthermore, it is proposed that a tender would be developed at the same time, should one, some or all of the obligated parties decide to explore outsourcing the activity to an independent third party/parties. This may well be preferable depending on how the current MiFID 1 and particularly MiFID 2 and/or EMIR rules are applied to power markets. Whilst writing this response, we are aware that the European Parliament text for MiFID 2 proposes that all commodities should be treated as if they were financial products, even though this is not currently the intention of the Commission text which contains exclusions for power trading. We also note that should ultimately the European requirements for financial instruments apply in some form to market makers in the power markets, then this will significantly increase the cost of such an activity should it be undertaken by an obligated party as originally envisaged.

iii. *Platforms* – There is already more than one platform used for the purposes of power trading. At the commencement of the obligation, we consider this should be effected that the obligated parties should be allowed to use any platform with the proviso that there are a significant number of licensed participants (obligated or non-obligated) using that platform. In addition, the platforms have to be capable of meeting the requirements placed upon the Market Makers and any other appropriate platform rules.

As an integral requirement, any platform or platforms, must be capable of handling both Over the Counter or cleared products. We would look to Ofgem to be involved in fleshing out the platform rules.

iv. *Products* – It is considered that there should be a product range which would also be phased and is a mix of base load and peak. For example, the base load products of month+1, month+2, quarter+1, season+1 and season+2 should be in Phase 1, alongside the peak products of month+1, month+2 and season+1. However, final decisions in this area can only be taken in conjunction with other trading criteria and in addition the exact nature of the content and phase would be determined by the response of the market. This is another aspect which Ofgem needs to keep under continuous review.

v. *Availability* – Ofgem originally proposed that market makers should be available for 50% of the opening hours of the market. Whilst being cognisant of the reasons behind this Ofgem proposal, and being sympathetic to this as an ambition, the majority of the members believe that two windows (one in the morning and one in the afternoon) are more likely to deliver an outcome that provides better liquidity and price discovery. Consideration has been given to the timing of the windows and their duration with one option being a morning window from 10.30-11.30 and the afternoon window 15.30-16.30. The timing of the afternoon window is particularly important and needs to reflect the timing of the gas market. We believe that it is also likely that the periods before and after the window opening/closing may well show increased liquidity.

vi. *Bid offer spreads* – We note the constraints proposed by Ofgem to the bid offer spread and have sought to substantiate the proposals with further analysis from the market in order to assist in confirming or otherwise the Ofgem proposals. RWE npower provided analysis in which the data it collected was compared with that provided by Ofgem. The RWE npower data demonstrated a wider average market bid/offer spread than has been proposed. We also recognise however, that the data has been collected under current market rules, and during both liquid and illiquid periods. As the introduction of two windows during the trading day is to improve liquidity, this in turn may produce tighter bid offer spreads than are currently implied by the market. Further, the introduction of Market Making will also have the potential to result in a market significantly different to that which is currently being presented.

It is difficult to determine final outcomes at this stage and how the market will respond. However:-

The consensus[1] view of the Obligated and Non Obligated Parties is that the appropriate requirement should be:

- **0.5% for Baseload products and 0.9% for peak Phase 1 to season + 2;**
- **0.6% for Baseload products and 1.2% for peak Phase 2 to season + 3.**

Both obligated parties and the independent generators are in agreement that the solution to Schedule B will not have longevity unless the bid offer spread is demonstrably fair to all parties.

We expect that the regulator will review the Market Making activity of each obligated party to ensure that appropriate spreads are posted for an acceptable duration. If

[1] With the exception of one obligated party; Another is continuing to review the data;

Ofgem is unable to rationalise the observed differences between the expected Market Making activity and the ex-post observed Market Making activity, or there are unexplained differences between the obligated counterparty and other Market Makers, the regulator may then ask the obligated party to justify objectively its Market Making activity.

vii. *Trade size* – the industry agrees the 5MW and 10MW trades to be offered at all times. It is important however that this is linked with the introduction of the Supplier Market Access rules proposed under Schedule A.

viii. *Daily volume cap/reset each day per window* – The industry considers that the most appropriate way of operating a daily volume cap would be to have a 30MW nett position for each of the 13 products suggested, for each Market Maker and available at each window. At this stage however, we are as yet unsighted as to whether there are unintended consequences and further work is on-going to determine what these may be and what mitigating actions can be taken.

ix. *Reload* – The industry favours product reloading within five minutes.

5. Next Steps

We have set out these proposals representing a compromise position agreed amongst our broad membership. It is anticipated that individual companies will respond separately setting out their key issues from a single company perspective.

Whilst each individual company view may differ in some regard to those expressed in this paper, we would like to stress the importance and validity of the compromise it contains.

We also seek to work closely with Ofgem to finesse the detail within the proposals, including for example, within areas such as Monitoring, Compliance, the tender process and discussions on the content of both Fast Market and Force Majeure rules.

Lastly, this consultation response is evidently only one step in the ongoing development of more liquid trading arrangements. We will continue dialogue across the broad membership of Energy UK to provide further responses where we see this will add value.

Should you require further detail then please feel free to contact Barbara Vest, Director of Generation, Energy UK.

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