



Martin Bell  
Wholesale Markets  
Ofgem  
9 Millbank  
London  
SW1P 3GE

Alan McAdam  
Economic Regulation Manager  
RWE npower PLC

2<sup>nd</sup> August 2013

**Wholesale power market liquidity: final proposals for a “Secure and Promote Licence condition – RWE response**

Dear Martin,

We welcome the opportunity to respond to Ofgem’s consultation on wholesale power market liquidity: final proposals for a “Secure and Promote Licence condition (‘the Consultation Document’) and the associated impact assessment. This response is provided on behalf of RWE npower, RWE Generation SE, RWE Supply and Trading GmbH and the UK subsidiary of RWE Innogy GmbH, RWE npower renewables.

We do not believe that Ofgem has made the case to justify an intervention on the scale envisaged in the consultation document. We currently operate in Europe’s most successful and competitive retail market, with effective competition between six large and many already successful independent suppliers. In this context, intervening in the wholesale electricity market to impose a market-making obligation to deliver enhanced retail competition appears to be a disproportionate response to the problems associated with barriers to entry for small suppliers. The intervention comes with the risk of significant distortion and cost to the wholesale market and a high cost to consumers against unquantified and questionable benefits.

Our previous consultation responses have indicated that any obligation to act as a market-maker should be non discriminatory and based on commercial terms. We are therefore very concerned to see that the licence condition will only apply to certain generators, will do so in a discriminatory fashion and is based on non-commercial mandated bid-offer spreads. To prove acceptable, there should be greater flexibility in the licence condition, including, for example, spreads based on historical commercial levels, provisions that more closely reflect the commercial risks for the obligated parties (such as a fast market clause) and arrangements that allow suspension of obligations if threshold volumes are met.

Our answers to the specific questions in the Consultation Document and Impact Assessment are included as Annexes to the letter. If you have any comments or wish to discuss the contents of this letter then please do not hesitate to contact me.

Yours sincerely

Alan McAdam  
Economic Regulation Manager

## **Annex 1: Wholesale power market liquidity: final proposals for a “Secure and Promote” Licence condition – RWE response to questions**

### **Question 1: Do you agree with our updated assessment of the wholesale market (set out in this chapter and appendix two)?**

We welcome Ofgem’s analysis of the GB electricity market in Chapter 1 and Appendix 2 and the evidence presented on market liquidity and availability of products. However, we do not agree that this demonstrates that the “*market is still not meeting the needs of market participants*”<sup>1</sup> While we recognise that small suppliers may encounter difficulties in entering the competitive retail market, these difficulties largely relate to the genuine, underlying costs of credit and collateral associated with operating in a market derived from volatile commodity prices.

Ofgem has also failed to provide any evidence that the current wholesale market is failing to deliver effective competition to customers or any evidence that the proposed intervention will promote effective competition in the supply of electricity. Rather the proposed intervention will distort and undermine competition in the already competitive wholesale electricity market by introducing potential costly obligations on a small number of obligated parties. The key metrics presented by Ofgem such as churn demonstrate effective competition while the level of OTC trading of forward products represents the efficient hedging strategy of market participants. More importantly, however, Ofgem’s metrics do nothing to indicate that intervention is required in the wholesale electricity market nor that such intervention will actually do anything to enhance retail competition.

Ofgem has also failed to account fully for a further range of Government policy interventions - including electricity market reform - that are having a chilling effect on the electricity market. These interventions create new risks for incumbents and entrants alike and – while many features remain uncertain - will themselves deter any party seeking to play a more active role in the UK market. Ofgem must consider the effects of these wider developments prior to considering the necessity of intervention in the wholesale electricity market.

### **Question 2: Do you agree with our conclusion that we should intervene in the market in the form of the ‘Secure and Promote’ licence condition set out in this document?**

No. We do not agree that the evidence presented in Chapter 1 and Appendix 2 justifies intervention via a “secure and promote licence condition”. In particular, such a profound intervention in the wholesale electricity market is out of proportion to the problem under consideration, namely supply business competition.

### **Question 3: Do you agree with our proposed legal approach to S&P?**

We cannot agree that a licence condition on generators to operate in wholesale markets is necessary or sufficient to deliver greater domestic retail market competition via the prospect of new entry.

While we do not support the proposed intervention, the decision to define the obligations in the licence and move away from a “Trading Requirements Document” sitting outside the licence is a welcome development. The proposed arrangements now have a robust governance process that provides the correct checks and balances to future changes. Nevertheless, we are concerned that

---

<sup>1</sup> Wholesale power market liquidity: final proposals for a “Secure and Promote” Licence condition – RWE response (The Consultation document), Page 6

the pendulum has swung too far in the other direction and that mandated bid-offer spreads are to be hard wired and enduring in the licence without appropriate checks and balances that would enable generators to manage effectively the terms of the intervention. In this context we believe it would be appropriate to consider additional terms that protect licensees from unlimited regulatory risk and unforeseen and disproportionate costs of complying with the obligation. There should also be a review/drop-dead date included in the licence condition. It needs to be made clearer as to when other companies become eligible or indeed, obligated parties become ineligible for the obligation. What happens if an obligated parties market share reduces significantly or a retail business is sold.

**Question 4: Do you agree with our proposals for who should face the obligations under S&P?**

No. We do not agree with Ofgem's proposals for allocating the Secure and Promote obligations. Ofgem has failed to provide:

- Any justification why a condition aimed at improving retail market competition should be imposed on generation licensees and then only a sub-set of licensees;
- Any justified link between the obligations on generators to the presumed objective of retail market competition. (Even then we assume that the focus is domestic retail market competition given already rigorous competition and entry in non-domestic sectors.)
- Any means to reflect the disproportionate impact of the obligations in terms of licensees' ability to mitigate and recover those costs given widely different retail market shares.

It is our view that if Ofgem continues to impose such a condition in generation licences it should be a standard licence condition, switched on in all generation licences, to avoid discrimination and distortion of the wholesale market. As a minimum those parties providing access to peak shape should be included in the Market-Making obligation, namely Drax and GdF. Ofgem should also develop conditions to scale the obligations better to reflect licensees' position in the market and ability to recover the associated costs.

**Question 5: Do you have any views on our final proposals for the Supplier Market Access rules, particularly those aspects listed under 'key outstanding design questions'?**

We are concerned that the Supplier Market Access rules are too prescriptive in their current form and that obligated parties should be given greater flexibility and longer-lead times to reflect the practical realities of progressing requests to enter into trading agreements. Furthermore parties should be entitled to suspend negotiations for good reason (with the reason to be provided) and should be able to reflect the additional cost of holding market risk on non-standard clip sizes where these are requested by qualifying suppliers.

With regard to the proposals we have the following specific comments:

- A3 – Response to trading requests: The timescales to respond to a written request within 2 working days is extremely challenging, 15 working days would be more appropriate;
- 4 & 5. If after 60 working days and a further face-to-face meeting there is no agreement we do not believe that further negotiation is likely to find a solution. The requirement under 5 should be dropped and the differences recorded; and
- The consultation document refers to a credit transparency form which will be provided by Ofgem. We would like to see early sight of a draft template for this to better judge what Ofgem has in mind.

With regard to the key outstanding design issues we have the following comments.

- **Scope:** We believe that the licence condition should apply to all supply licensees. This avoids the potential for market distortions arising from the obligation falling onto only selected parties.
- **Credit and Collateral:** The licence condition should make it clear for the avoidance of any doubt credit and collateral are commercial terms to be agreed by the parties. The SMA rules should make it clear that credit is not a one-off assessment – therefore once we have a trading relationship this does not create an ongoing obligation if credit status changes.
- **Response to trading requests:** As noted above there should be greater flexibility in the timescales to enable parties negotiating in good faith to enter into commercial arrangements.

We believe that Supplier Market Access (Liquidity Licence Condition Schedule A) should be amended to include the following elements

- Flexibility and longer-lead times are required to reflect the specific circumstances associated with requests to enter into trading agreements;
- Either party should be entitled to suspend negotiations for good reason (reason to be provided); and
- Added fees should include the cost of holding market risk on non-standard clip sizes

#### **Question 6: Are there any further areas that these rules should cover?**

We do not believe that the rules should cover any further areas.

#### **Question 7: Do you have any comments on our proposed detailed design for the market making obligation, particularly those listed under ‘key outstanding design questions’?**

With regard to the “key outstanding design questions” we have the following comments.

- **Finding the appropriate balance of costs and benefits:** We believe that Ofgem has underestimated the costs for obligated parties and hence the costs to customers of the proposed intervention in the absence of clear evidence on the benefits. The result will be high costs for obligated parties with limited benefits for customers.
- **Limiting bid-offer spreads:** As noted in the consultation document, the proposed bid offer spread is a crucial element in considering the potential costs for obligated parties and the associated risks. As noted below, Ofgem must better tailor the obligation to mitigate the costs and risks associated with mandated bid-offer spreads.
- **Alternative delivery mechanisms for market making.** We welcome Ofgem’s consideration of alternative mechanisms for market making. We would support a third party approach, however, further work and more time is required to determine whether such an approach is feasible, The risks faced by obligated parties and consumers appear likely to remain even if industry engages a third party to discharge the obligation.
- **Costs:** We believe that Ofgem has underestimated the costs associated with market making by an order of magnitude and that costs could rise as high as £15m per obligated party (compared to Ofgem’s estimate of total ongoing costs of £2m per party).

We believe that the following changes would minimise the impact on costs:

- Increasing the bid-offer spreads to just outside historic ranges improving confidence that prices reflect historic trends and underlying market fundamentals;
- Introducing a volume threshold so that the market making obligation is not unlimited (i.e., when traded volume reaches a threshold the obligation ceases (but would recommence if volumes fall));
- Introducing a “fast market” clause that releases obligated market makers from the requirement to post prices in extreme circumstances (standard practice in market making agreements);
- Reducing the percentage of time that the obligated market makers have to quote prices over a defined period to a de minimis level (say 25% of the time);
- Decreasing the complexity of implementation and introduction by ensuring that the mandated bid-offer spread is based on p/MWh rather than a percentage of the price;
- Ensuring that mandated spreads are subject to review and consultation under a prescribed process from time to time Introducing a linkage between the Market Maker bid/offer and the underlying market (e.g. linked to volatility) such that higher the volatility, the higher the spread;
- Profiling the bid/offer spreads in line with underlying historic market liquidity;
- Reducing the term to front month, front quarter, front season with commercial terms outside of these;
- Ensuring that minimum clip sizes for market making of 10MW so that the current level of liquidity is maintained;
- Linking the obligation to the size of the relative size of the supply business with the large obligated parties required to market make more than smaller parties; and
- Ensuring a process to suspend the obligation at times of significant market disruption (e.g., as observed during the financial crisis);
- Releasing obligation parties from the licence conditions if the arrangements are subject to MIFID/EMIR

**Reporting:** We remain concerned about the ongoing burden of regulatory compliance and reporting required by the licence condition.

**Question 8: Do the detailed elements of the proposed market making obligation appropriately balance costs and risk for the licensees?**

We do not believe that the proposed market making obligation appropriately balances costs and risk for the licensees. Ofgem’s impact assessment materially understates the costs of the intervention. The only “risk free” strategy for managing open positions is to go immediately back into the market to reverse the position at the next available price. This would have costs which are materially greater than the cost assumed by Ofgem but lower than the alternative. We explain our rationale in the comments on Ofgem’s impact assessment below.

Ofgem also concludes that *“if S&P results in increased competition it could produce benefits (through reductions in margins, in operational costs, or in combinations of the two) which could clearly exceed the costs of S&P”*<sup>2</sup>. However, we note that:

- The benefits are not quantified and the obligation is on certain parties who will face increased costs;

---

<sup>2</sup> Consultation Document, Page 33, paragraph 33

- The obligation is imposed in the generation licence and will affect the wholesale market; and
- There is no evidence presented that increased prospect of new entry in the supply market results in “*better offers to customers*”<sup>3</sup> or reduced “*operational costs*”<sup>4</sup> for the obligated parties (generators)

Consequently we do not understand how Ofgem can conclude that the cost benefit case for S&P is “*likely to be positive*”<sup>5</sup>.

**Question 9: Do you believe that an industry-run tender process could more successfully deliver our proposals for a market maker? If so, do you have views on how we can solve the practical challenges we have identified?**

We support market solutions and believe that government/regulatory interventions do more harm than good. We would support a tender run process for market making on commercial terms or in order to establish the cost of the obligation so that a proper cost benefit analysis can be undertaken.

**Question 10: Do you agree with our analysis of the costs, risks and benefits of intervening in the near-term market?**

We agree with Ofgem’s analysis of the costs, risks and benefits of intervening in the near term market.

**Question 11: Do you agree that we should not intervene in the near-term markets at this stage?**

Yes; Ofgem should not intervene in the near term market either now or in future. We support market solutions and believe that government/regulatory interventions in the area of wholesale markets do more harm than good.

---

<sup>3</sup> Consultation Document, Page 33, paragraph 33

<sup>4</sup> Consultation Document, Page 33, paragraph 33

<sup>5</sup> Wholesale power market liquidity: final proposals for a “Secure and Promote!” licence condition – draft impact assessment (the Impact Assessment ( Impact Assessment)), Page 33, Paragraph 5.21

## **Annex 2: Wholesale power market liquidity: final proposals for a “Secure and Promote” licence condition – Draft Impact Assessment: RWE Response to questions**

### **Question 1: Do you agree with our evaluation of the impact of our Secure and Promote proposals on consumers? Are there other factors we should be considering?**

We do not agree with Ofgem’s evaluation of the impact of the Secure and Promote proposals on consumers. Ofgem has failed to provide any quantitative analysis in support of this intervention that demonstrates that there will be a benefit to the consumer. Instead Ofgem make a set of assertions in support of the intervention including the following statements:

- *“if liquidity allows generators to compete more effectively, then this could lead to downward pressure on profits earned from generation, as firms have a reduced ability to earn excessive returns.”<sup>6</sup>*
- *“if S&P allows them [retailers] to manage their risks better by trading a range of longer-dated products, then this may help suppliers to compete more actively on the price they offer to consumers”<sup>7</sup>.*
- *“The impact of increased liquidity on bills may be easier to identify for the elements under the direct control of suppliers”<sup>8</sup>; and*
- *“Increased competition facilitated by improved liquidity should encourage suppliers to price more keenly, creating downward pressure on consumers’ bills”<sup>9</sup> “.*

However, there is no evidence that generators operating in the competitive wholesale have any opportunity to earn “excessive returns” or that the proposed intervention will have the any material impact on competition in the wholesale energy market or in the retail market.

Furthermore, Ofgem state that the intervention will require a 0.3% reduction in operational costs and a 0.4% reduction in profit margins to offset Ofgem’s estimates of the ongoing costs of the intervention. This implies that in the absence of the imputed benefits outlined above, costs for customers will have to rise to cover the costs associated with delivering the service for the obligated parties. Clearly if costs rise by at least this amount for obligated parties, the costs for non-obligated parties are consequently lower which in itself will distort and impede effective competition. Ofgem has not evaluated the extent or impact of this distortion in terms of increasing costs to consumers by encouraging inefficient competition and entry.

### **Question 2: Do you agree with our evaluation of the impact of our Secure and Promote proposals on competition? Are there other factors we should be considering?**

We agree that improvements in liquidity are of benefit to the market and consumers in allowing all market participants to manage their risks more efficiently and in ensuring access for potential new entrants. As a company, we already provide significant liquidity to the market by trading multiples of our underlying volumes and have been a leading player in market-led initiatives to promote further liquidity. We cannot agree that liquidity levels are currently so poor as to justify regulatory intervention particularly given that such intervention is likely to distort competition and unlikely to deliver a net benefit to consumers. While more liquidity would always be welcome, current levels of liquidity are nevertheless adequate for parties to be able to trade their positions efficiently and

---

<sup>6</sup> Wholesale power market liquidity: final proposals for a “Secure and Promote” licence condition – draft impact assessment (the Impact Assessment ( Impact Assessment), Page 13

<sup>7</sup> Impact Assessment, Page 13

<sup>8</sup> Impact Assessment, Page 14

<sup>9</sup> Impact Assessment, Page 14

effectively given uncertainties over energy prices, demand forecasts and the current fast-moving and uncertain energy policy landscape.

Ofgem's regulatory intervention on the obligated parties to market make will produce a regulated outcome. Consequently the market will be distorted by the intervention.

**Question 3: Do you agree with our evaluation of the impact of our Secure and Promote proposals on sustainable development? Are there other factors we should be considering?**

We do not agree with the evaluation of the impact of our Secure and Promote proposals on "sustainable development". Ofgem assert that the S&P market maker intervention will "*improve the robustness of forward prices*" and that this "*may help the market to provide the CfD reference price*".<sup>10</sup> However, we believe that robust prices can only be made by markets responding to competitive pressures and not the outcome of regulatory interventions. Moreover, there seems an inherent circularity in attempting to justify a non-market intervention in an already working and competitive market on the grounds that it provides a better price for partial settlement of contracts struck at prices determined outside of the competitive market.

**Question 4: Do you agree with our evaluation of the cost impacts of our Secure and Promote proposals? Are there other factors we should be considering?**

We do not agree with the cost impacts of Ofgem's Secure and Promote proposals and in particular the underlying assumptions associated with market making. The only "risk free" strategy for managing open positions from market is to go immediately back into the market to reverse the position at the next available price. Ofgem suggests that "*this strategy seems potentially expensive*"<sup>11</sup>, and indeed it does incur significant cost. Instead Ofgem suggests that the licensee with the open position will "*wait for firms to trade in the opposite direction*"<sup>12</sup>. Whilst Ofgem acknowledge "*when a firm has open positions it will incur the risk that the price changes in the meantime – the cost associated with this will arise from holding an amount of risk capital*"<sup>13</sup>.

Ofgem's suggested strategy is only economically rational if the cost of holding the position is less than the cost of immediately reversing the position. We provide a potential range of risk capital costs for holding an outright power position as suggested by Ofgem. The range of costs ranges from £0.15/MWh to £0.81/MWh, significantly higher than our estimated cost of £0.17/MWh of immediately reversing the position.

These costs demonstrate that a rational market maker would immediately reverse out of the position and that following Ofgem's proposed approach would significantly increase the potential cost of market making yet further. Ofgem's best estimate of the total market making cost is just over £2m per obligated party. Our estimate is that this cost is closer to £15m per obligated party.

**Question 5: Do you agree with our evaluation of the risks and unintended consequences of our Secure and Promote proposals? Are there other factors we should be considering?**

We agree that there are a number of risks and unintended consequences associated with the proposed intervention. However, the impacts of these are difficult to quantify and predict.

We are particularly concerned about uncertainty over the impact of European financial regulation in the event that the obligation leads the market and its participants into the realm of full banking sector regulation. We believe it would be prudent if the licence condition contained a clause that

<sup>10</sup> Impact Assessment, page 23, paragraph 4.4

<sup>11</sup> Impact Assessment, page 29, paragraph 5.12

<sup>12</sup> Impact Assessment, page 29, paragraph 5.12

<sup>13</sup> Impact Assessment, page 29, paragraph 5.12



enables suspension of the obligation in the event that European financial regulation impacts on market making.

We would also welcome provisions for Ofgem to suspend the obligations at short notice to deal with difficult or extreme market conditions (e.g., those following the financial crisis) or in the event that the obligation leads to unforeseen and undesirable trading behaviour (e.g., artificial patterns of trade which solely reflect gaps between market and regulated spreads).

