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for energy consumers

Centrica Energy Limited
Millstream
Maidenhead Road
Windsor Berkshire
SL4 5GD

Your Ref:
Our Ref:
Direct Dial: 0203 263 9676
Email: Cathryn.Scott@ofgem.gov.uk
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Dear Colleague,

REQUEST FOR MODIFICATION OF SPECIAL CONDITION AA OF ELECTRICITY GENERATION LICENCES HELD BY CENTRICA GROUP

On 11 December, Centrica Group ('Centrica') formally requested that Ofgem begin the process of removing Schedule B of the Special Condition AA from their Electricity Generation Licences. Centrica is currently subject to Schedules A, B and C of this licence condition. Schedule B relates to the Market Making Obligation ('MMO').

Centrica's main argument in support of their application relates to changes in the group's strategy. Structural changes have led them to sell some of their generation assets, thereby reducing their market share when compared to 2014. Centrica considers that, as a result of changes in their generation market share, they should no longer be subject to Special Condition AA: Liquidity in the Wholesale Electricity Market.

We have assessed Centrica's request against the non-exhaustive criteria outlined in our 2014 Guidance Note ('Guidance Note')¹. This letter sets out the background to the request and explains our reasons for consenting to it. To give effect to the changes, pursuant to Paragraph AA.1 of the Special Condition, today we have published a direction covering the Electricity Generation Licensees in the Centrica group. We have considered our statutory duties and in particular our principal objective in making this decision.

Background

Special Condition AA: Liquidity in the Wholesale Electricity Market became effective on 31 March 2014. The condition was designed to tackle relatively low levels of GB electricity wholesale market liquidity, identified as potentially detrimental to retail competition as far back as our Energy Supply Probe in 2008.

Liquidity is an important feature of a well-functioning market for a number of reasons. Liquid wholesale energy markets give market participants the confidence that they can buy and sell at prices that reflect underlying demand and supply conditions. They allow firms to manage risk effectively and reduce the scope for market manipulation. Importantly, they also provide transparent prices on which non-vertically integrated generation and supply

¹ Liquidity in the Wholesale Electricity Market (Special Condition AA of the electricity generation licence): Guidance. <https://www.ofgem.gov.uk/ofgem-publications/86717/liquidityinthewholesaleelectricitymarketspecialconditionaaoftheelectricitygenerationlicence-guidance-pdf>

businesses can base their investment decisions, and potential entrants can assess opportunities to enter the market.

Special Condition AA aims to improve liquidity in three ways:

- **Schedule A - Supplier Market Access Rules:** Seeks to improve the availability of products that support hedging, by requiring the eight largest electricity generating companies to follow a set of rules when trading with small independent suppliers. These include defined standards for dealing with requests for trading agreements, pricing, products and minimum clip-sizes.
- **Schedule B - Market Making Obligation:** Seeks to ensure the availability of robust reference prices for wholesale electricity products along the forward curve. Five² large vertically integrated generation and supply companies are required to simultaneously post bids (buy) and offers (sell) orders for specified forward wholesale electricity products on energy trading platforms throughout two daily trading windows.
- **Schedule C - Reporting Requirements:** Monitors forward and near-term market liquidity by imposing reporting requirements on obligated licensees.

Assessment criteria

We have assessed Centrica's request in accordance with the Guidance Note, which sets out the factors we take into account when removing the licence condition.

Paragraph 1.10 of the Guidance Note contains the criteria that we will use as the basis of any decision on whether to remove or add Schedules A, B or C of the licence condition. These criteria are:

- Changes to generation market share:** Any significant and sustained changes in the generation market share or generation output of a company group, taking into account its relative market share and overall size.
- Disproportionate risks or costs:** An indication that an existing Secure & Promote ('S&P') licensee will face disproportionate costs and risks in continuing to meet the licence condition, or that a potential new S&P licensee could meet the costs and risks proportionately.
- Success of the licence condition:** The sustained successful achievement of the objectives of this licence condition.

In addition to the above, the Guidance Note also specifies a fourth factor that will be used when considering whether to add or remove Schedule B of the licence condition.

- Changes to supply market share:** Any significant and sustained changes in the domestic supply market share or volume supplied of a party, taking into account its relative domestic market share and overall size.

Taken together (i and iv), these are intended to reflect circumstances where there is a fundamental change in the structure of a business, which may impact upon the ability of a licensee to meet the requirements of the licence condition.

² These are Centrica Energy, Scottish and Southern Energy plc, Scottish Power plc, EDF Energy and RWE Npower plc. Schedule B was originally included in E.ON's licence condition, but it was removed in November 2016 following E.ON's divestment of Uniper.

Supporting evidence and our assessment

The following paragraphs contain Centrica's evidence to justify the removal of Schedule B from the group's Electricity Generation licences and our assessment of Centrica's request, in accordance with the Guidance Note.

Changes to generation market share

When the S&P licence condition was introduced in March 2014, Ofgem used generated metered volume data to assess Centrica's market share as approximately 8% of the market.³ Our latest assessment using this data shows Centrica had a market share of 5% in 2017.⁴ Centrica highlights that after analysing published data from BEIS, which uses electricity generation capacity installed in the UK, Centrica's market share was 4.5% in March 2014 and 0.8% at present. While the use of different data sets produces different valuations of Centrica's current and historic market share, both show a notable decrease since 2014.

Since 2015, there have been changes to Centrica's strategy, resulting in Centrica reviewing its position in energy asset ownership. Centrica has exited from wind generation, disposed of Langage and South Humber CCGTs and shifted its portfolio to small licence-exempt distributed assets.

Centrica state that the only licensable power plants owned by Centrica are Barry and Peterborough, which are contracted under Short Term Operating Reserve ('STOR'). These power plants are therefore under the instruction of National Grid and any electricity produced is transferred directly to National Grid. Centrica does not receive any of this output.

Centrica currently receives 20% of the generated power from EDF's nuclear fleet through a Power Purchasing Agreement ('PPA'). However, this nuclear generation is transferred to Centrica's supply hedging division at the market price and therefore there is no financial advantage associated with the PPA.

Centrica also highlight that while E.ON still holds 1.8% of the UK's installed generation, E.ON received an exemption from Schedule B of Special Condition AA after its spinoff of the majority of its generation assets.⁵ Based on Centrica's data, we understand that Centrica now have less installed capacity than E.ON. Our decision to exempt Centrica from the MMO on the basis that it no longer has a significant GB electricity generation portfolio is therefore consistent with our decision on E.ON/Uniper.

A basis for Ofgem subjecting parties to the MMO is a substantial presence in both generation and domestic supply markets. Centrica believe the reduction of their market share means they no longer have a significant presence in electricity generation. We agree with their assessment, with this being a key factor in our assessment of whether Schedule B should be removed from Centrica's licences.

³ Based on metered generation volume and interconnector imports. Generation shares are based on proprietary data. Station demand has been excluded. For Centrica, the figure takes into account Centrica's 20% stake in GB's nuclear generation fleet. Please see 2015 Great Britain and Northern Ireland National Reports to the European Commission for more details: https://www.ceer.eu/documents/104400/3737359/C15_NR_GB-EN.pdf/ca0390a9-b6a2-bd9b-cb33-d17e65428e56

⁴ Wholesale electricity generation market shares by company in 2017 (GB): <https://www.ofgem.gov.uk/data-portal/wholesale-electricity-generation-market-shares-company-2017-gb>

⁵ Request For Modification Of Special Condition AA of E.ON's And Uniper's Electricity Generation Licences. https://www.ofgem.gov.uk/system/files/docs/2016/11/e.on_uk_special_condition_aa_letter.pdf

Disproportionate risks or costs

Centrica state that the costs involved in complying with the MMO have increased over time. They state the costs incurred in 2016 due to market volatility were substantially above those forecast in Ofgem's 'high case' scenario⁶.

Centrica considers that they have faced disproportionate and unfair costs in meeting the licence condition. They believe they have had very limited control over these costs and high costs incurred in 2016 were not unique. Combined with the structural changes to Centrica, they believe that they cannot fulfil the MMO without exposure to disproportionate costs and risks.

We recognise wholesale market volatility in Winter 2016/17 is likely to have increased the costs of the MMO for obligated parties. However, we note that the long-run average costs have been in line with Ofgem's initial cost forecast.⁷ We therefore believe that the costs and risks associated with engaging in MMO are not disproportionate for Centrica.

This means that to continue to meet the MMO, it is likely that Centrica would need to buy power from the wholesale market specifically to sell in the market making windows. As Centrica has reduced its generation market share, we consider that Centrica has no advantage over any other non-vertically integrated suppliers in the market. While the costs Centrica have incurred are broadly in line with our long-run estimates, we recognise that the changes to Centrica's structure may have increased costs relative to a vertically integrated generator/supplier (i.e. buying electricity to meet the obligation).

Success of the licence condition

Centrica state that wholesale market liquidity has increased under several metrics. They note that the volume of longer dated contracts has increased from 262 TWh in 2013 to 441 TWh in 2016, and that there are 2.5 times more suppliers in the market than in December 2013.

Centrica therefore conclude that the objectives of the licence condition have been met and sustained. They believe the removal of the MMO from Centrica's generation licences would not compromise these achievements.

We note that many indicators of liquidity in the wholesale market have increased since the introduction of the S&P licence condition. There has been a slight increase in the volume of contracts traded, especially in the volume of longer dated products. A total of 1,104 TWh of wholesale electricity was traded in GB during 2017. This is an increase of 17% on total traded volume in 2013.

Bid offer spreads on mandated products have also decreased, from more than 1.8% in 2010 to approx. 0.5% in 2017. This gives market participants confidence that they can buy and sell without significant transaction costs.

However, near term liquidity has stayed broadly stable since the introduction of S&P. Exchange traded volumes day-ahead and within-day have remained constant. We note that although there has been an increase in the volumes of contracts traded within the market making window, trades outside of the windows in the mornings and evenings have decreased.

⁶ Wholesale power market liquidity: statutory consultation on the 'Secure and Promote' licence condition - Impact Assessment: <https://www.ofgem.gov.uk/ofgem-publications/84511/impactassessment-wholesalepowermarketliquidity-statutoryconsultationonthesecureandpromotelicencecondition-pdf>

⁷ At the time of our original impact assessment, we estimated that the ongoing costs of complying with MMO would be around £2.4m per licensee per year.

Centrica also note that there has been an increase in the number of suppliers operating in GB.⁸ However, we do not think this can be attributed to S&P.

We consider that while a number of liquidity indicators have improved, the objectives of the S&P licence condition are yet to be fully realised. Total OTC trading was only 779 TWh in 2017, down from 1,083TWh in 2016 and churn averaged 3.7 in 2017, down from an average of 4.7 in 2016. We therefore believe that the S&P licence condition cannot yet be considered a sustained success.

Changes to supply market share

Centrica note that while their market share of domestic electricity consumers was 24% when the S&P licence condition was introduced, this has since reduced.

According to Ofgem data, Centrica's current domestic market share is 20%⁹. As Centrica still have the largest share of domestic customers, we do not believe this constitutes a significant change in market share and would justify the removal of Schedule B on this basis alone.

Our decision

For the reasons set out above, we consent to Centrica's request to have Schedule B of the Special Condition AA removed from its Electricity Generation Licences.

As noted earlier, parties subject to the MMO should have a substantial presence in generation and domestic supply markets. This is consistent with our previous decisions not to subject licensees without a significant GB electricity generation and domestic supply market shares to undertake market making activities. We believe there has been no significant change to Centrica's supply market share, with Centrica remaining the largest domestic supplier. However, we agree that changes to Centrica's business mean they no longer have a significant GB electricity generation market share and that this impacts the group's ability to meet the requirements of Schedule B.

With regard to the other criteria, while we recognise there was an increase in Centrica's compliance costs in 2016, we consider that the long-run costs incurred by Centrica have so far have been in line with our long-run cost forecast.

We also note that while there have been improvements to liquidity in some areas, the policy cannot yet be considered a sustained success.

Our overall assessment is that it would be appropriate, at this stage, to remove Schedule B from the Electricity Generation Licences held by Centrica.

To implement these changes, today we have issued a licence direction to coincide with the publication of this letter. If you have any questions relating to this letter, please contact Heather Stewart on Heather.Stewart@ofgem.gov.uk or at 0141 354 5436.

Yours sincerely

Cathryn Scott,

Director, Wholesale Markets and Commercial

⁸ There were 24 active suppliers in GB in June 2014. This had risen to 69 by the end of December 2017. <https://www.ofgem.gov.uk/data-portal/number-active-domestic-suppliers-fuel-type-gb>

⁹ Electricity supply market shares by company: Domestic (GB): <https://www.ofgem.gov.uk/data-portal/electricity-supply-market-shares-company-domestic-gb>