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Making a positive difference
for energy consumers

To all stakeholders

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Dear colleagues,

In August we published an open letter seeking views on the suspension of Schedule B of Special Condition AA of the Generation Licence (the Market Making Obligation, "MMO") pending further review of the provision[1]. Our open letter was published alongside our consent to Centrica's request to remove the MMO from its electricity generation licences, on account of changes in their generation market share[2].

We were concerned that the MMO aspect of Secure and Promote could become less effective in meeting its original objectives for a well-functioning wholesale electricity market, namely: (i) availability of products which support hedging; (ii) robust reference prices along the curve; and (iii) effective near-term markets. This was due to the removal of Centrica and the potential future removal of other obligated parties as a result of industry transactions. We were also concerned that the reduction in the number of obligated parties could result in disproportionate costs for remaining market-makers.

Having considered stakeholder feedback on the likely impacts of its suspension, we have decided not to suspend the MMO immediately. However, if the corporate transactions planned by three of the obligated parties are completed, it is likely that the obligated parties would apply to Ofgem to release them from the MMO and in that event, we do not think the MMO, as currently designed, could continue. Therefore, market participants should prepare for the suspension of the MMO if both the SSE/Npower merger and the acquisition of Scottish Power's thermal generation units by Drax complete. The public announcements on these transactions suggest this is likely to be by the end of the first quarter of 2019. This letter summarises stakeholder responses, explains the reasons for our position, and outlines next steps.

Summary of stakeholder responses

We received forty-one responses to our open letter, predominantly from generators, suppliers, and energy traders[3].

1) Views supporting suspension

Ten respondents supported suspension, most often on an immediate basis. These respondents included five of the original obligated parties and companies that have recently taken steps towards greater vertical integration.

[1] https://www.ofgem.gov.uk/system/files/docs/2018/08/ofgem_open_letter_-_secure_and_promote_update.pdf
[2] https://www.ofgem.gov.uk/system/files/docs/2018/08/centrica_special_condition_aa_decision_letter.pdf
[3] All non-confidential responses are published on our website alongside this letter.

The key arguments made across respondents concerned:

(i) The likely impacts and risks of suspension for the market

Five of the respondents who favoured suspension challenged the effectiveness of the MMO in improving liquidity and expected suspension to have a positive or negligible impact on the market. Several of these stakeholders argued the MMO had not improved overall liquidity but rather concentrated it in the market-making windows or created an illusion of liquidity in the windows through obligated parties trading with each other to close out their positions. Respondents cited a fall in traded volumes of forward products outside the windows, of non-mandated products, and of overall trading per annum since the introduction of the policy in support of their view that the policy has been ineffective. Another respondent suggested suspension would have a positive impact on liquidity. This stakeholder argued the MMO undermines suppliers' ability to hedge their demand by creating a perverse incentive for non-obligated parties to rely on the obligated parties' trading activity and prices for their bilateral trades, rather than actively participating in the market.

(ii) The proportionality of costs on the remaining obligated parties

Nine of the ten respondents in favour of suspension referred to disproportionate costs and credit risk for the remaining obligated parties as their number reduces and their trading volumes increase. Two respondents argue that costs will outweigh the benefits and several emphasised that costs will increase further due to increased price volatility in combination with increased trading volumes. One respondent suggested it will become increasingly difficult for the obligated licensees to manage the size of positions and the associated costs with increased volatility in spite of the volume cap.

(iii) Qualifying evidence to support suspension and related timing

Three respondents suggested that, in absence of a robust counterfactual to fully evaluate the effectiveness of MMO, suspension should be used as a tool to test natural liquidity. These parties anticipated that suspension would have a negligible or even positive impact on the effective functioning of the market.

2) Views against suspension

Thirty respondents were against suspending the MMO. These responses were predominantly from independent suppliers, generators and energy traders.
The key arguments made across respondents concerned:

(i) The likely impacts and risks of suspension for the market

The majority of respondents anticipated suspension having an immediate detrimental impact on the functioning of the market. They expected liquidity to fall in absence of the MMO with a reduction in the number of available products and volumes traded and resulting wider spreads. Pre-MMO levels of liquidity and volumes and spreads outside of the market-making windows were cited as reference points for the likely impact of suspension. Several independent parties emphasised the importance of the MMO for their trading, with the majority of their trades being executed in the windows.

Fifteen respondents emphasised the importance of the MMO for robust price discovery for their trading activity, including for their bilateral trades and power purchase agreements, which enable them to hedge. Accordingly, rising trading costs and wholesale prices were predicted as a risk to both those trading in the market and those working through third-parties which would most likely result in higher costs being passed on to consumers. The majority of these respondents considered these direct costs and price discovery impacts would be particularly detrimental when combined with the move to PAR-1, EU exit, and the implementation of the default tariff cap for domestic suppliers.

A recurring view was that suspension would have a disproportionate impact on smaller suppliers who would be less able to mitigate rising costs through reviewing their purchasing strategies or creating other cost efficiencies. Twelve respondents argued that many small suppliers may no longer be able to access the market through trading agreements with third-parties, with the reasons given including that they would face higher credit and collateral requirements.

(ii) The proportionality of costs on the remaining obligated parties

Several respondents pointed to a lack of clear, quantifiable evidence that the cost impact on remaining obligated parties was sufficient to merit suspension. Two respondents, including a former obligated party, cited the combined generation market share of the remaining four licensees of around 50% in support of the proportionality of costs on obligated parties. Another respondent cited the volume cap as mitigation against the risk of excessive costs.

(iii) Qualifying evidence to support suspension and related timing

Twenty-two respondents cited insufficient evidence and assessment of the costs and benefits of the MMO to justify suspension. Many respondents said that it was premature to consider suspension in light of prospective market developments rather than realised changes. Several respondents said that given some parties stated dependence on the market-making windows for their trading, suspension should only be considered after a full evaluation of the impacts has been completed. Others said that suspension should be considered after another reduction in the number of obligated parties. One respondent argued that it would be difficult to assess the impacts of suspension in general given that views on the market are not conclusive.

There was a general consensus that the timing of any potential decision to suspend should be made clear in advance along with the accompanying process and milestones for reaching a decision. Thirteen parties emphasised the need for sufficient lead time to adjust their hedging strategies and business models.

3) Review of the MMO

There was broad support for a review of the impacts of the MMO as soon as possible in light of the changing market structure. Two respondents specifically said that the application of the MMO to vertically integrated companies was increasingly arbitrary or unfair due to changing business models and the Competition and Market Authority's assessment that vertical integration was not a barrier to competition. Several others, who were against suspending the obligation immediately, recognised that the MMO in its current form would be unviable with further reductions in the number of obligated parties.

4) Views on alternative options to the MMO

Many respondents provided views on their preferred changes with the majority suggesting a tendered market-maker funded by socialised costs. The second most common alternative suggestion was to widen the obligation to include other generators and retailers. Several of these respondents also suggested changes to the volume, spread, product and timing requirements of the MMO as part of the review, to improve efficacy and protect obligated parties from excessive costs. Two respondents also suggested examining restrictions on trade between affiliated companies.

Some respondents suggested that changing market conditions (with less vertical integration and increased new entry) have increased the number of participants for trading, contributing towards liquidity, and potentially changing the objectives of any future policy development. There was also reference to price transparency available from other sources, and the default tariff cap on domestic suppliers which may change the need for a market-making mechanism.

Reasons for our position

The MMO is having a significant influence on trading activity in the market and the availability of products that are important for some market participants' hedging activity. Whilst it is difficult to quantify the full impacts of suspension on the market, feedback suggests that immediate suspension of the MMO could lead to a significant disruption of the market which could lead to increased costs and reduced access for smaller parties. In addition, we have not received clear evidence that the current four obligated parties will be subject to disproportionate costs or that the benefits of the MMO could not be sustained with these market-makers. Our overall assessment of the issues, taking into account responses to our open letter, is that it would not be in consumers' interests to suspend the MMO immediately.

However, market developments have occurred since we published our open letter that support the case for suspension in future. Planned corporate transactions by three of the remaining companies with the MMO in their generation licences have been announced or moved closer to completion, with implementation expected by the end of the first quarter of 2019[4]. Assuming these corporate transactions take place, there will be only one remaining party that meets the criteria for the MMO[5], down from six when the policy was introduced. Under such circumstances, we expect the policy to become less effective as with only one remaining obligated party, the MMO may not generate a robust reference price.

Stakeholder feedback highlighted the importance of clarity on the future of the obligation and advanced notice of suspension to allow for a lead time for parties to adapt. Market participants should therefore prepare for suspension of the MMO in the event that the corporate transactions planned for the first quarter of 2019 complete. The timing of these corporate transactions are not in Ofgem's control.

Next steps

We will continue to monitor market liquidity. Given our updated position and market developments, we think it is appropriate to consider whether the original policy objectives still hold. Therefore, we will continue to investigate longer-term policy options and alternatives to the MMO for promoting market liquidity.

We would welcome stakeholder views on the appropriate objectives of any future liquidity policy support and longer-term alternatives to the MMO. To discuss further, please contact: Pooja.Darbar@ofgem.gov.uk.

Yours sincerely

Cathryn Scott,
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[4] On 10 October 2018, the Competition and Markets Authority (CMA) approved the anticipated merger between the domestic retail energy business of SSE plc and Npower Group Limited; on 16 October 2018, Scottish Power announced the sale of its generation subject to approval by Drax's shareholders and conditional upon the approval of the CMA.

[5] These criteria are explained in our guidance document and are based on ability of a firm's generation licensees to deliver the obligation at proportionate costs taking into account overall size, generation output and market share, and the firm's domestic supply market share or volume supplied: https://www.ofgem.gov.uk/ofgem-publications/86717/liquidityinthewholesaleelectricitymarketspecialconditionaaoftheelectricitygenerationlicence-guidance-pdf