12 October 2018

Proposed Suspension of the Market Maker Obligation

Dear Dermot

We would like to inform you of the serious concerns we have about Ofgem's proposal to suspend the Market Maker Obligation (MMO). MMO has improved our access to wholesale electricity products, although liquidity in the GB wholesale market remains worse than many other markets, such as Germany and France. Liquidity will likely worsen if MMO is suspended.

MMO's suspension will have a significant and material negative impact on fair wholesale market access, in particular for non-vertically integrated suppliers.

We are also concerned about the apparent absence of due process, provision of meaningful impact assessment, or formal consultation thus far. This seems inconsistent with the likely significant material impact on us.

We do not think the MMO should be suspended until Ofgem has undertaken, published and consulted upon, a thorough review of Secure and Promote (S&P) and the MMO. If Ofgem does suspend MMO, we would hope any review would be conducted as promptly as possible and the current somewhat vague timetable is made more specific, with interim delivery milestones, so stakeholders can monitor progress. We also propose that if the MMO is suspended, Ofgem closely monitors the market and if liquidity deteriorates, the suspension is swiftly revoked.

Unexpected letter

We were very surprised by the content of Ofgem's letter (dated 9 August 2018), where its intention to suspend MMO was first announced. This appears an abrupt change in Ofgem's previously stated policy positions and plans. For example, in December 2017 Ofgem stated: "[we] feel that any significant changes at this point [to

MMO], including the removal of the policy, could jeopardise the support on which some participants rely".

In the December letter, Ofgem also suggested new ways of reducing the costs for MMO parties, including the introduction of a soft landing period at the start of the trading window and a new "fast market" rule. No approaches to lowering MMO costs have been attempted.

Evidence MMO is delivering on Ofgem's three liquidity objectives
There is evidence MMO is delivering against Ofgem's liquidity objectives.

1) ***There has been a 20% increase in churn since S&P was introduced, but liquidity has yet to reach the level Ofgem argued represented healthy level of liquidity***

2) ***Bid Offer spreads have decreased on mandated products***

Ofgem highlights the importance of bid-offer spreads on its website:

"The bid-offer spread is one indicator of market liquidity. It is the difference between the best bid to buy and the best offer to sell. It measures the premium an urgent buyer must pay if it wants to buy and the discount an urgent seller must make if it wants to sell. Tighter spreads suggest a more liquid market and robust pricing.

"Liquidity is an important feature of mature markets, often reflecting a large number of buyers and sellers. Liquid markets also facilitate new entry by making it easier to buy and sell electricity at a good price. For example, in a liquid market a new supplier can more easily enter the market and buy the power they need to cover their consumers' demand whilst also having confidence in the price they are paying."

Ofgem's own data shows that the bid-offer spread on certain mandated products has more than halved since MMO was introduced in March 2014[1]. If Ofgem decides to suddenly suspend the MMO we expect that liquidity will decline to a lower level than that before MMO was introduced. Ofgem's data shows that suspending the MMO would likely result in spreads tripling (before MMO the reported % price spread is 0.81% and after MMO it was 0.30%). This would significantly and disproportionately increase the cost of hedging for suppliers. We urge Ofgem to incorporate consideration of costs to the wider industry and GB consumers into its thinking.

Suspending MMO at short notice would significantly and suddenly increase costs for independent suppliers to meet their hedging needs, just ahead of winter and at the same time as the cost of being out of balance will increase significantly with the full implementation of the Electricity Balancing Code Review[2] (EBSCR). Aside from the

[1] https://www.ofgem.gov.uk/data-portal/wholesale-market-indicators. Ofgem report price spreads for day-ahead (non-mandated), front month, front quarter, front season, second season, third season, fourth season. The prices are those reported by ICIC Energy at 16:30, so at the end of the market making window.
[2] https://www.ofgem.gov.uk/electricity/wholesale-market/market-efficiency-review-and-reform/electricity-balancing-significant-code-review

impact on liquidity and prices, MMO suspension will also require hedging strategies, credit, and risk controls to be revisited. This will be costly and will take time. Suspending MMO without providing market participants sufficient time to arrange alternative routes to efficient hedging will result in significant and unanticipated costs.

We do not think it will be possible for the market and independent suppliers to fully mitigate these costs. There is nothing Ofgem can do (in the short term) to mitigate the decline in liquidity the suspension of MMO would cause, but we think a notice period of at least 6 months before any suspension of MMO would provide a sensible window for independent suppliers to mitigate some of our other costs, if Ofgem is intent on continuing to suspend MMO.

3) *Useful benchmark for price discovery*

Default Tariff Price cap
Ofgem's analysis for the default tariff price cap indicates one likely consequence will be a reduction in wholesale liquidity. This could be exacerbated by the suspension of the MMO.

Ofgem's wholesale model requires a robust reference price for wholesale energy as an input so it has a good proxy for suppliers' wholesale costs. Ofgem proposes to use the MMO market reference price to determine the wholesale element of the price cap. However, Ofgem's analysis to date does not take account of the proposed suspension on MMO so it does not accurately reflect wholesale market condition under which the default tariff cap will be introduced at the end of this year (ie after the proposed suspension of MMO in November).

The lower volume of trades that is likely to result from the suspension of MMO will reduce liquidity, increase price volatility and increase bid and offer spreads. The net result could be that the reference price (which is an average of bid and offers) becomes a less robust measure of the real wholesale energy costs suppliers incur. The reduction in liquidity also means it becomes easier for parties to manipulate the reference price to affect the price cap.

We suggest Ofgem's analysis should also investigate whether there is any difference in impact between vertically and not vertically integrated suppliers, since vertically integrated suppliers are likely to be able to better manage their wholesale cost following the suspension of MMO.

Contracts for Difference
The Contracts for Difference (CfD) regime also uses a wholesale reference price to calculate the CfD 'strike price'. This also depends on a liquid market providing a meaningful reference price. As mentioned previously, the suspension of MMO will likely reduce liquidity and thus decrease the robustness of the CfD price. This means consumers could end up paying more to support the CfD regime.

Other points

Ofgem proposes to change the residual charges under the Targeted Charging Review, moving all charges onto demand. If this change is to be neutral on consumers, generators must pass on their residual charges savings via the wholesale market. An illiquid market means it is likely less of the savings will be passed through to consumers.

The suspension of MMO could act as a barrier to market entry, and reduce financial viability of some smaller suppliers. The knock on impact of that could be a reduction in competition within the energy market, which could result in increased costs for consumers. These impacts should be modelled in an Impact Assessment.

Some of us are seeking meetings with Tom Corcut and Catheryn Scott at Ofgem to talk through these issues. We would, of course, be very pleased to meet with you to discuss this.

Yours sincerely

David Bird, CEO, Co-op Energy
Stephen Harris, Energy Director, Ovo Energy
Colin Crooks, CEO, First Utility
Stuart Jackson, CFO, Octopus Energy
Phil Brown, Head of Commercial, BES Utilities