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SECURE AND PROMOTE UPDATE – OPEN LETTER DATED 9 AUGUST 2018

Dear Ms Scott

Statkraft UK is pleased to respond to your request for views on potential courses of action outlined in your open letter to stakeholders¹ concerning the Market Making Obligation (MMO)² under Secure and Promote.

Statkraft is a leading company in hydropower internationally and Europe's largest generator of renewable energy. The Group produces hydropower, wind power, solar power, gas-fired power and supplies district heating. Statkraft is a global company in energy market operations with 3500 employees in 16 countries.

Statkraft UK has been operating since 2003. We have over 500 MW of UK generation plant, as majority owner and operator of four onshore wind farms, owner of a large hydropower plant. Statkraft in the UK is the leading provider of long-term power purchase agreements (PPAs) for renewable electricity generation with a portfolio exceeding 8 TWh of primarily renewable generators. Statkraft is also active in electricity supply targeted at industrial customers and in energy services.

The MMO obligation brings liquidity and price transparency at set times; this is greatly appreciated by our PPA customers and it allows them to fix prices in an efficient manner. The liquidity provided by this window allows us to handle the risk posed by this portfolio of intermittent generation much more effectively. In addition, we trade during these windows to hedge the risk arising from a small retail business.

¹ https://www.ofgem.gov.uk/system/files/docs/2018/08/ofgem_open_letter_-_secure_and_promote_update.pdf
² Schedule B of Special Condition AA of the Generation Licence

Your open letter provides a summary of the rationale for a direction to remove Centrica Group's MMO obligations and sets out a number of possible courses of action outlined in the letter. These are:

- a review of the MMO criteria;
- a review of other potential mechanisms for delivering market making;
- whether the remaining MMO obligated parties will incur disproportionate costs and risks in meeting the licence condition; and
- if there is a case for the suspension of the MMO during the review (you indicate this will conclude in 2019).

We have provided our views on each of these below.

Review of the MMO criteria

Your document³ sets out a number of (non-exhaustive) factors that are used to determine if a licensee is subject to MMO obligations under Secure and Promote. In summary, these are:

- substantial changes in generation market share or output when taking into account relative market share and overall size;
- indication that a new / existing licensee faces proportionate / disproportionate costs / risks in meeting the licence condition;
- the objectives of the licence condition are met and continue to be met; and in the case of the MMO
- substantial changes in domestic supply market share or volume supplied when taking into account relative domestic market share and overall size.

Together with other factors that may be taken into account, we believe the areas covered by these remain valid for assessing whether a party should be obligated to provide the MMO. As part of your review, we suggest you consider thresholds applied in these areas. You note that there has been evolution in both the market and the business structures [of participants]. There are now 106 active suppliers compared to 36 at the time Secure and Promote was introduced in 2014 and the market share of independent suppliers has risen to over 23% compared to 6% at that time⁴. On the generation side, distributed capacity is in excess of 30GW and the market is witnessing the breakdown of the vertically integrated model⁴.

The absolute level of any thresholds that were applicable when Secure and Promote was introduced need to be reviewed for today's market conditions. This provides an opportunity to clarify future arrangements and if appropriate expand definitions / criteria to obligate the right number of participants under the MMO for today's market

Maintaining the number of participants subject to the MMO would avoid costs / risks being placed on a shrinking number of parties. This could be achieved by introducing a minimum number of MMO parties and/or exploring if the MMO should be applied to generation and supply parties separately (i.e. without considering any net position across group companies). It will also help ensure that the objectives of the licence continue to be met on an enduring basis.

³ https://www.ofgem.gov.uk/sites/default/files/docs/2014/03/liquidity_in_the_wholesale_electricity_market_special_condition_a_of_the_electricity_generation_licence_-_guidance.pdf

⁴ Cornwall Insight Energy Spectrum 632, 03|09|2018

Finally, the initiation of a review to establish whether a party (or parties) should be subject to the MMO could be parameterised more fully and transparently with published trigger points and criteria. This would provide clarity to the market and reduce uncertainty.

Review of other potential mechanisms for delivering market making

Under the current MMO arrangements, liquidity is concentrated within the trading windows. Any mechanisms that have the potential to meet or exceed the overall objectives of Secure and Promote and deliver for end consumers should be explored. Such exploration must be timely and complete – both benefits and costs must be considered alongside the practicalities of implementing any solution. We would welcome the opportunity to comment further on any options as part of the review process.

One way to encourage liquidity across the day may be to extend the duration of the current windows. This could be on every trading day, selected days of the week or on a seasonal-day of the week basis.

In considering which mechanisms may deliver market making, we believe you must consider the wider regulatory environment. Particularly what attracts players into the market and what has caused some to leave. We believe that regulation plays a key part in these decisions. The market is subject to a number of regulatory requirements (e.g. MiFID, REMIT) and further uncertainty around additional regulation is unhelpful and ultimately increases costs for end consumers.

Disproportionate costs and risks associated with meeting the MMO licence condition

In the consultation⁵ issued at the end of 2017, information provided by licensees on the cost of complying with the MMO is presented. Only one year is significantly higher than the others, which you note show costs below your original estimates.

The MMO includes aspects to help limit costs to obligated licensees under certain circumstances and although you proposed enhancing these³, you have decided not to implement any changes.

Costs and risks cannot be considered in isolation. There is no robust analysis or information on benefits derived directly or indirectly from the MMO. Any review must explore and quantify benefits more fully than they have been to date. Information on costs must also be captured and quantified in a comparable way from different parties.

It is important to weigh any costs against benefits for current arrangements before considering whether changes to current arrangements are justified. Price and volume movement protections exist within the current MMO and amendments to these should be considered, along with alternative mechanisms for cost recovery (e.g. from the wider market rather than just MMO obligated parties).

The MMO provides benefits to the wider market beyond those for parties directly participating in transactions with the obligated parties. Of particular importance is the benefit of price discovery for the whole market across the MMO horizon and product range. Without the MMO, price benchmarks will be more limited (e.g. ICIS Heren <https://www.icis.com/energy/power/>) and therefore the value of this cannot be ignored. Price discovery is a fundamental aspect of any well-functioning market. Market reference prices derived from a liquid market have a wide application are used directly or indirectly in a number of areas. Examples include:

⁵ https://www.ofgem.gov.uk/system/files/docs/2017/12/december_2017_consultation_final.pdf

- bi-lateral transactions / contractual arrangements (e.g. PPAs, shaped products and are used by large consumers to lock-in prices under flexible supply arrangements);
- pricing for a number of schemes introduced by BEIS (or its predecessors) such as Contracts for Difference (which is seeing an increase in eligible baseload assets), the Renewables Obligation and the small-scale Feed-In Tariff scheme.

Removing the MMO is likely to reduced liquidity and therefore confidence in price discovery at a time when a fair market reference price of increasing importance to a growing number of parties.

Is there a case for suspending the MMO during the review?

We do not see that this course of action is sufficiently substantiated. The guidance document on Secure and Promote⁶ sets out success criteria for the licence condition. In order to propose suspension of the MMO as a course of action, we would expect a robust cost-benefit analysis together with evidence of improvement in a range of metrics since the introduction of Secure and Promote (e.g. a significant increase in churn) to support this. We do not consider suspension of the MMO pending a review is appropriate.

Further we note that your letter gives no indication that consideration has been given to possible impacts on parties trading and benefitting from the MMO as well as for the wider market.

Without any details of the timing and process for suspension (including that for re-instating the MMO), the proposal has created additional uncertainty in the market and increased regulatory risk in a way that should have been avoided. It is not possible for participants to see how a suspension may affect their hedging (and so pricing) or to see how this change could fit with other changes, such as changes to the safeguard tariff⁷ and the reduction of the Price Average Reference to 1MWh (known as PAR1)⁸ from 1 November 2018.

Uncertainty around timing extends beyond a possible suspension date to when (or if) any reinstatement of the arrangements may take place following the review. This could lead to participants incurring higher costs to reinstate activities. Any decision should be evidenced by a robust cost-benefit analysis and relevant supporting information.

In summary, we

- do not believe the MMO should be suspended now – evidence to support this as a course of action has not been presented and the implications have not been considered fully;
- see the removal of the MMO as detrimental to a number of individual parties, who will see access to wholesale markets severely limited almost overnight and the wider market where confidence in price discovery will be dented and liquidity will diminish;
- suggest that significantly more work must be undertaken to assess and quantify the benefits of the MMO so that these can be properly weighed against the costs;
- think a review of the MMO and other options for market access should be carried out against a timetable published in advance. A review has effectively been

⁶ https://www.ofgem.gov.uk/sites/default/files/docs/2014/03/liquidity_in_the_wholesale_electricity_market_special_condition_a_of_the_electricity_generation_licence_-_guidance.pdf

⁷ <https://www.ofgem.gov.uk/publications-and-updates/ofgem-increases-level-safeguard-tariff-due-higher-wholesale-costs>

⁸ <https://www.elexon.co.uk/mod-proposal/p305/>

"running" since 2017 and without details of timings for this latest stage, it is unclear that it will conclude in 2019.

We hope our views will be useful as you formulate and progress this work. We would be pleased to discuss further the points that we have raised in this response – please get in touch if this is of interest.

Yours sincerely,
for Statkraft UK Ltd

A handwritten signature in blue ink, appearing to read 'David Flood', with a stylized, cursive script.

David Flood
Managing Director, Statkraft UK Limited