

London, 20th September 2018

RE: Ofgem's Open letter regarding next steps for the Market Making Obligation

Dear Cathryn,

Thank you for the opportunity to respond to your open letter on the future of the Market Making Obligation (MMO). This response represents the view of the Centrica group of companies. This response is non-confidential and can be published on Ofgem's website.

Centrica relies on the wholesale market for sourcing electricity for its customers and we are concerned that the MMO is having negative impact on the market to the extent that it is compromising our ability to source electricity in the most efficient way. We believe that the MMO as designed is constraining rather than helping liquidity to develop and therefore its suspension is likely to have positive impact on liquidity and the overall functioning of the wholesale market. In that respect, we also recommend that Ofgem calibrates properly the announcement of the suspension to avoid unexpected reactions.

We strongly support a review of the MMO criteria and other potential mechanisms for delivering genuine liquidity in the wholesale electricity market. However, should Ofgem proceed with the suspension, we believe it would be advisable to observe the market for at least a year to see how the market performs without obligations.

In the meantime, Ofgem should gather input on ideas concerning how a different, less intrusive, mechanism may better improve liquidity in the electricity market without distorting the way the market works. The period of observation will help inform Ofgem and market parties to understand whether any regulatory intervention is still required.

We assume that the Supplier Market Access obligation of the Secure & Promote policy and the reporting requirements not specifically linked to the MMO will continue to apply, but we ask Ofgem to clarify this point in its final decision.

The negative impact the MMO is having on the wholesale electricity market suggests a suspension is warranted

On balance, we believe it would be preferable to suspend the MMO, as per Ofgem's minded-to position, pending a review. This is because, rather than enhance the wholesale market, the MMO as designed is damaging the market to the extent that it is undermining suppliers' ability to hedge their demand. As we have noted in previous responses, there is clear and unambiguous evidence that the MMO has distorted the market as trading has concentrated in the mandated trading windows. This has occurred due to the perverse incentive on non-obligated parties to rely on obligated parties' trading activity and prices to settle their bilateral deals, rather than participate actively in the market.

The entire wholesale market suffered because of this development. First, it has clearly had a serious limiting effect on how suppliers can hedge their demand. Before the MMO was introduced, trading could take place consistently throughout the day whereas currently this trading is forced into just two hour-long windows.

In addition, it creates a disconnect with the wholesale gas market, which contrary to the wholesale electricity market, trades constantly throughout the day. Traders looking to trade spreads between power, gas and carbon need to change their power positions in response to developments in related markets throughout the day. Traders that seek to execute a spread trade will also want to complete the power and gas legs simultaneously rather than being forced to leave the power leg exposed until it can be closed during the next window.

We support the proposed review but it should only be launched after the market has been observed functioning without intervention

Centrica believes that the wholesale market should be given the opportunity to function without the MMO. We believe it would be sensible for Ofgem to observe the market for at least a year to see how it performs without any mandated market making mechanism. In the meantime, Ofgem should gather input and develop options about different mechanisms to improve liquidity e.g. tendering the market making and/or liquidity provision services against remuneration. Centrica would support less intrusive and more efficient mechanisms to improve liquidity in the electricity market.

It should be noted that there are also several external developments that are due to take place over the next 6 months that could have an impact on liquidity and trading strategy and short delay in launching the review would allow these the effect of these developments to be considered.

The main external developments that should be considered in the review are:

- A power exchange recently introduced an initiative for liquidity provision which has been highly appreciated by prospective counterparties. This is essentially a voluntary market making service and is likely to have a positive impact on liquidity.
- The introduction of the Retail Price Cap is likely to lead to a change in suppliers' hedging strategy. Given that the Cap will not be known beyond the coming season, suppliers are unlikely to hedge beyond this period. This will therefore reduce the demand for products with the same tenor as currently provided for by the MMO.
- The conditions under which the UK leaves the European Union next March, and the UK's relationship with the EU ETS, could also have a bearing on liquidity and price volatility.

When the review is launched it should consider several options to replace the MMO (assuming Ofgem does suspend the obligation as per the 'minded-to' position) and focus on reducing barriers for new traders to enter the market (e.g. reduce collateral for balancing) and / or tendering out the market making role or other measures to improve liquidity.

We hope this response is helpful. If there are any of the points raised in this response that you would like to discuss in more detail feel free to contact me at riccardo.rossi@centrica.com.

Yours sincerely,

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