Response to Ofgem Open letter: Secure and Promote Update

20 September 2018

EP UK Investments (EPUKI) is a non-vertically integrated power generation company with a requirement to hedge and optimise output from nearly 2.7 GW of generation capacity. The market making obligation has benefitted our company by providing confidence that baseload and peak products can be traded in defined windows and that the largest parties in the market must transact within the terms set by the regulator. We are therefore extremely concerned that Ofgem is proposing to suspend the market making obligation without any analysis of the potential impacts of this change and without a plan to ensure ongoing market liquidity. While recent changes in the market may warrant a review of Secure and Promote, we cannot see a case for suspending the obligation until the results of this review are known.

EPUKI has been supportive of the market making obligation since its introduction in 2014 and considers that it plays an important role in mitigating the effects of vertical integration in the electricity market. We recognise that the number of obligated parties has been reduced and that future changes in company structures could decrease this number still further, but we consider that for the time being vertical integration remains a significant feature of the market that may affect the ability of companies such as ours to trade easily on reasonable terms, particularly further along the curve.

As a power generator with limited trading resource, the current liquidity windows give us certainty about when to seek to transact rather than having to monitor the market at all times. A high level of liquidity concentrated within these windows is preferable to lower levels of liquidity spread throughout the day. The market making obligation is therefore facilitating market access and guaranteeing liquidity in many products. The benefits of the market making obligation for companies such as ours was recognised by Ofgem as recently as December 2017 when it stated that 'We feel that any significant changes at this point, including the removal of the policy, could jeopardise the support on which some market participants rely'.

We are concerned that levels of liquidity would fall immediately upon removal of the market making obligation. With the obligation already removed from some parties, there is the risk that liquidity may fall anyway and a complete suspension of the obligation could make this worse. We are surprised that Ofgem has neither published any analysis of this risk before proposing to suspend the obligation nor provided a plan to encourage ongoing liquidity should removal of the obligation have this effect.

The rationale for suspending the obligation appears to be based on a belief that other market developments would support high levels of liquidity. We have not seen evidence to support this assumption and do not consider that this would be the case. Our experience is that levels of liquidity outside of the products mandated under the market making obligation are poor and that liquidity would therefore not be guaranteed without the obligation. There are a number of increasingly important products (such as individual EFA blocks and extended peaks and overnights) which are illiquid. We consider that vertical integration may be contributing to this illiquidity and increasing costs and risk for non-vertically integrated companies. As part of its review of the market making obligation, Ofgem should consider whether there is a case for extending the range of mandated products which are covered by the obligation.

We note that no evidence has been published to support the statement that the reduced number of obligated parties 'may result in an undue burden being placed on the remaining obligated parties'. Previous analysis by Ofgem suggested that the cost to obligated parties was within the range envisaged in the Impact Assessment for the policy. Ofgem has also previously developed proposals to mitigate the costs faced by obligated parties during periods of volatility, which could be implemented immediately. We are therefore not convinced that the costs borne by the remaining obligated parties are sufficiently high to warrant an immediate suspension of the obligation. Furthermore, an analysis is required of the potential increase in costs and risk to smaller market participants should the market making obligation be removed as this could be of a similar or greater magnitude to that faced by the obligated parties.

EPUKI recognises that there are questions about the design of the market making obligation given the change in the structure of obligated companies. We consider it appropriate that Ofgem should review the obligation and consider any amendments or other mechanisms that could be used to guarantee liquidity going forward. However, we do not consider it reasonable to suspend the obligation while this review is undertaken. Doing so would be inconsistent with the principle of evidence-based decision making and could jeopardise market liquidity without any plan to maintain it at or restore it to current levels.

We hope that Ofgem will appropriately consider the above and maintain the market making obligation until its broader review has concluded. We would expect Ofgem to consult with market participants on the findings of that review and its proposed next steps.