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Wholesale Markets and Commercial
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Dear Cathryn,

Secure and Promote: Proposal to suspend the Market Making Obligation

ESB Group welcomes the opportunity to respond to Ofgem’s open letter on the Secure and Promote (S&P) special licence condition. Our operations in Great Britain include 1.45GW of existing generation capacity, plus a strong pipeline of development projects, and a small domestic supply business. We trade on the wholesale power markets to support both of these operations. This gives us a strong insight into the effect the Market Making Obligation (MMO) has on the market and the benefits it provides to consumers.

Our understanding of your position

Six large, vertically integrated suppliers were initially obliged to provide the MMO. Two of these companies have recently divested their generation portfolios and you have removed the MMO from them. As a result of this, you are reflecting on the fundamentals of MMO provision and its future application. You plan to complete a review of the MMO sometime in 2019. You are considering whether the remaining obligated parties will face disproportionate costs and risks in continuing to provide the MMO and are minded to suspend its operation. However, you have also stated that while the MMO has improved liquidity, you do not think the market has enough liquidity to justify its removal.¹

Our views

We do not believe that suspension of the MMO during the period of review is the correct course of action. We do not understand how the burden on the remaining providers will become disproportionate given the mitigating measures put in place to prevent this on introduction of the policy. In contrast the MMO continues to provide a number of clear and substantial benefits to consumers. Suspension would lead to a loss of these benefits. We urge Ofgem not to pursue a suspension and instead to dedicate available resources to replacement of the MMO with a more sustainable solution as soon as possible. We set out our rationale below.

MMO costs and risks

Your original impact assessment² split the ongoing cost of market making into four categories:

	Low Case	Best Estimate	High Case
<i>Staff costs</i>	£80,000	£220,000	£220,000
<i>Transaction fees</i>	£50,000	£550,000	£1,100,000
<i>Cost of open positions</i>	£750,000	£750,000	£1,500,000
<i>Costs from managing credit exposures</i>	£89,000	£928,000	£2,024,000
<i>Total annual cost per S&P licensee</i>	£969,000	£2,448,000	£4,844,000

Staff costs are a relatively minor component of the cost of providing the MMO. We understand that the remaining costs for each provider (transaction fees, cost of open positions and costs from managing credit exposures) are subject to an availability volume cap and a trade size cap. These caps were designed to mitigate the costs and risks associated with providing the MMO. Unless the caps were in some way poorly designed, it is difficult to see how the costs of providing the MMO could become disproportionate for the remaining providers. It is simply not the case that the overall provision of the MMO carries a fixed cost and that as the number of obligated parties decline, that same cost is spread across fewer parties.

¹ Centrica derogation, pp. 4-5: https://www.ofgem.gov.uk/system/files/docs/2018/08/centrica_special_condition_aa_decision_letter.pdf

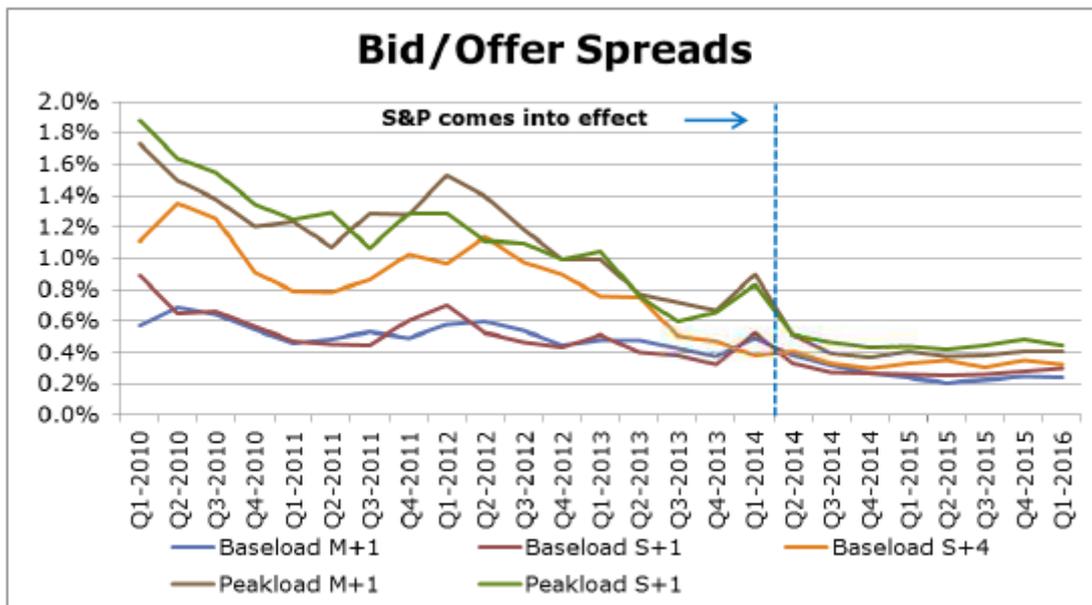
² https://www.ofgem.gov.uk/sites/default/files/docs/2013/11/impact_assessment_-_wholesale_power_market_liquidity_-_statutory_consultation_on_the_secure_and_promote_licence_condition.pdf

MMO benefits

Any change to market arrangements needs to be carefully considered in terms of both costs and benefits to consumers. A suspension of the MMO constitutes a change to the status quo and therefore must be considered in these terms.

In your November 2013 consultation,³ you stated that your objective for S&P was to ensure that the wholesale electricity market supported effective competition, delivering benefits to consumers in terms of downward pressure on bills, greater choice and better service. You stated that three characteristics were needed for the wholesale market to support competition effectively: the availability of products that support hedging, robust reference prices along the curve and an effective near term market. MMO was designed to deliver robust reference prices along the curve and it has been successful. The MMO guaranteed that a range of products would be available each day, which allowed new entrants, without the financial capacity for a trading function of their own, to sign market access agreements with larger trading companies. The agreements were in part based on the fact that the risk to the trading company was reduced as they would be able to pass the specific MMO products through to the smaller supplier. As a consequence, the number of suppliers in the market has grown substantially since the MMO was introduced.

If the MMO is suspended, we would expect the number of products available each day to fall and trading fees for smaller suppliers to rise substantially. These costs will be passed onto end consumers. Agreements between smaller suppliers and larger trading companies which reference the MMO products will be reviewed and potentially unwound. It is well known that smaller suppliers already face difficulties hedging in this rising wholesale market; the removal of the MMO will exacerbate this problem. In addition, without the regulated bid offer spreads, the market will likely revert to the wider spreads seen before Secure and Promote (see chart) which would lead to an increase in transaction costs. This disproportionately impacts smaller suppliers as they have much smaller risk limits than the larger companies, forcing them to cross these larger spreads, increasing their costs on each transaction. An impact assessment should be carried out to review the loss of benefits to parties currently using the MMO to hedge supply or generation positions; as referred to above, an extensive impact assessment was conducted prior to implementation of the obligation originally and the need to review and understand impact remains.



Source: Ofgem Wholesale power market liquidity: Annual report 2016

We believe that if the MMO were to be suspended, traded volumes would revert to pre-MMO levels. This would have a detrimental impact on ESB in terms of being able efficiently to hedge our generation assets as there would no longer be a daily guarantee that power products would be available to trade.

Finally, the loss of the MMO will mean the loss of a robust market reference price. This will have knock on implications for setting the retail tariff caps and the Contracts for Difference payments for low carbon generation. For example, if the retail tariff cap diverged from the real wholesale costs suppliers face, the result **could be higher than necessary prices for consumers or large numbers of suppliers exiting the market.**

An alternative way forward

You expect to see further consolidation among MMO providers. If the number of MMO providers continues to fall, at some point the remaining providers will hit their volume cap levels and the overall benefits of MMO will reduce. For this reason, we agree that the MMO needs to be reviewed and replaced as a priority. This would also present an opportunity to improve overall market liquidity, which should lower prices for consumers.

The costs of provision per supplier are capped and therefore individual burdens are limited. Even if its effectiveness reduces over time, some MMO benefits are better than no MMO benefits at all. We would strongly advise Ofgem not to suspend the MMO and instead focus resources on accelerating its review and replacement. Ideally, the new arrangements should be in place by winter 2019/2020. If Ofgem were to proceed with considering a suspension, any change in the existing market arrangements must be robustly underpinned by an impact assessment.

We would be more than happy to engage with you further on your proposals. Please do not hesitate to get in touch.

Yours sincerely,



Michael Quigley
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