

Co-op Energy Response to Ofgem open letter – Secure and Promote Update

September 2018

Dear Cathryn

Thank you for the opportunity to respond to Ofgem's open letter, published on 9 August 2018. In the letter you set out Ofgem's intention to suspend the Market Making Obligation (MMO) until you complete a review of the provision, which you anticipate completing in 2019.

We have serious concerns about your proposal to remove the MMO due to the likely negative impact on fair wholesale market access. For the avoidance of doubt, we do not think the MMO should be removed until Ofgem has undertaken, published and consulted upon, a thorough review of S&P and the MMO

In addition, the apparent absence of due process, provision of meaningful impact assessment, or formal consultation thus far seems inconsistent with the likely significant material impact on parties who find the MMO improves their access to wholesale electricity products.

Unexpected letter

We were very surprised by the content of the letter as it appears an abrupt change in Ofgem's previously stated positions and plans. In particular since you stated in December 2017 "[Ofgem] feel that any significant changes at this point, including the removal of the policy, could jeopardise the support on which some participants rely". At the same time, you also suggested 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.

Assessing the rationale for change

We appreciate there have been some changes in the market that may mean the costs of remaining MMO parties may increase and have caused you to change your view.

However a balanced review of the MMO must surely take account of the wider implications of the removal of MMO, including:

- 1) the wider competitive benefits of the MMO
- 2) how service users will achieve alternative market access.

Since neither of these has occurred, it appears premature to suspend the MMO obligations.

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Evidence MMO is delivering on Ofgem's three liquidity objectives

Furthermore there is evidence MMO is delivering against Ofgem's 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
- 3) Useful benchmark for price discovery

Impact on SVT price cap

The wholesale model Ofgem proposes to use to determine the level of the wholesale element of the price cap does not take account of the proposed suspension on 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. An unintended consequence of the suspension of MMO could mean the wholesale reference price becomes a less reliable indicator of suppliers' wholesale costs; carries a greater risk of 'gaming' the wholesale price to impact the wholesale allowance under the cap; and has disproportionate impact on non-vertically integrated suppliers.

For example, the lower volume of trades that is likely to result from the suspension of MMO will likely 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. The example of Libor demonstrates that regulated parties sometime game reference prices to increase profitability.

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.

Suggested next steps

Bring forward the promised review of MMO and focus on:

- How S&P has fostered market entry and growth for new suppliers
- What other market arrangements could replace MMO without placing undue costs on specific players
- Consider synergies with Ofgem's workstream reviewing supplier licencing regime and the impact the removal of MMO
- Assess the impact of MMO suspension on the objectives of the price cap

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We would be happy to meet with you to discuss any of the points raised in this letter.

Best wishes

Duncan Carter
Regulation Manager

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