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## Ofgem Open Letter on Schedule B of Special Condition AA of the Generation Licence (the Market Making Obligation) – 9 August 2018

EDF Energy welcomes the opportunity to provide views on Ofgem's minded to approach set out in its open letter regarding the Market Marking Obligations (MMO) within Special Condition AA of certain Generation Licences.

As a large nuclear generator with a high exposure to power prices, EDF Energy is a strong supporter of a robust and liquid wholesale market, with traded volumes that are far higher than any small supplier is likely to require. However, we believe the original rationale for implementing a market making obligation can no longer be justified, is unfair and imposes undue costs / risks on those parties who continue to be obligated. Furthermore, we believe a more sensible solution would be for a market making service to be provided on a commercial basis rather than a mandated approach.

We are therefore supportive of a prompt suspension of the MMO for all remaining obligated parties while Ofgem undertakes a robust review of the MMO criteria and other potential mechanisms for delivering market making. Our reasons for supporting Ofgem's proposed course of action are set out below.

### Application criteria - Vertical Integration

The original policy design of the MMO and its continued application to only vertically integrated companies can no longer be justified. Ofgem's focus on such companies at the time the MMO obligation was introduced was based on a view at the time that vertical integration provided an alternative to wholesale market trading not available to independent players. Ofgem believed that this option may be particularly valuable when liquidity is poor and participation by such parties in the wholesale market would be particularly beneficial.

However, during its Energy Market Investigation, the CMA found no evidence of such strategies concluding that there was no indication that the six large energy firms were gaining an advantage by systematically using internal trades of products that were not available to other, non-integrated (or less integrated) parties.

As Ofgem notes, since the MMO policy was introduced the market has evolved. Two of the six obligated parties have divested generation assets (e.on and Centrica), and if the

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proposed SSE/npower merger proceeds, npower would presumably seek to exit from the obligation also. In light of these events and given the CMA has effectively debunked the notion of vertical integration being a barrier to wholesale market liquidity, we no longer consider it acceptable for the obligation to continue in its current form.

If, following its review, Ofgem decide that some form of market making arrangement is required, it needs to be robust to such changes and reflect the more diverse pattern of generation asset ownership

**Undue Burden**

As we have previously indicated to Ofgem[1], the MMO obligation can impose disproportionate costs on obligated parties. This has been observed particularly during periods when wholesale prices are volatile and at the start of the market making windows where narrow mandated MMO bid/offer spreads interfered with price discovery. Ofgem recognised these costs in its December 2017 consultation and proposed two forms of mitigation (a "soft landing" rule and a new fast market rule). However, neither of these modest changes has actually been introduced leaving obligated parties exposed to such costs should market conditions again become volatile.

**Market Uncertainty**

The outcome of the UK's Brexit negotiations remains uncertain and the possibility of a no-deal outcome remains. This uncertainty is having a direct impact on energy markets, notably on the price of carbon given the uncertainty as to whether the UK will remain in, or closely linked, to the EU ETS post Brexit. These issues may well come to a head in the next couple of months, with the potential for increased market volatility over that period as a result.

The carbon price uncertainties are particularly acute for Winter 2020 (a period for which obligated parties will soon be required to trade) which straddles the potential date for the UK's exit from the EU ETS if this takes place at the end of December 2020 (which is both the proposed end of the Brexit transition period and the end of EU ETS Phase III).

Given the above, we believe that the Obligation should be suspended as soon as possible. More specifically, if it is not possible to suspend the Obligation entirely from 1st October, then the Winter 2020 period should not be brought into the Obligation on 1st October, only for it to be suspended a short period later.

Even if a Brexit deal is reached, its impact on the functioning of energy markets is also uncertain. In a no-deal scenario, it seems likely that electricity (interconnector) imports will no longer be frictionless. Wholesale prices in such circumstances may again become relatively volatile until market uncertainty is resolved/subsides. Continuing with a mandated market making approach through such periods is likely to impose significant risks on the mandated parties.

[1] EDF Energy letter to Cathryn Scott – 27 January 2017.

However, we acknowledge that during periods of such uncertainty, market participants are likely to want to continue to hedge and in doing so value a market making service. We believe a more sensible solution would be for this service to be provided on a commercial basis rather than a mandated approach which imposes costs on a limited number of participants.

**Ofgem Review**

Although the MMO has clearly increased liquidity in terms of traded volumes, we believe that a significant proportion of that liquidity is not "real" but instead reflects obligated parties being forced to open positions and immediately closing them. When we filter data to remove such trades we do not see a significant impact from MMO on liquidity.

As part of a review, and in the event that Ofgem do promptly suspend the obligation, Ofgem are likely to assess the ongoing evolution of market liquidity following the MMO suspension. It is important that Ofgem considers upfront what the key measures to be used are – for example traded volume (either raw or filtered as discussed above), bid-offer spreads, or availability of prices. While appropriate, it is important that any assessment takes account of other factors, such as Brexit and the Government's Tariff Cap, that are likely to be having an impact on the levels of market liquidity, such that simple year on year comparisons should be avoided. Ideally, the review should look at periods of time when such uncertainty is largely removed.

We are supportive of a further review by Ofgem of the MMO, including the extent to which there are other potential mechanisms for delivering market making. For instance, if suppliers see benefit in market making, they could sponsor its provision on a commercial basis, as exists in other markets. On the basis that no party is dominant in the wholesale electricity market, there is no reason to believe that it would not be possible to agree normal commercial terms for the provision of such a service.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact Steven Eyre on 0208 1861356 or myself on 01483 489576.

I confirm that this letter may be published on Ofgem's website.

Yours sincerely,

**Paul Delamare**
**Head of Customers Policy and Regulation**