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Dear Cathryn,

Secure and Promote: Suspension of the Market Making Obligation

We are concerned about Ofgem's minded-to position to suspend the Market Making Obligation ("MMO") in Schedule B of Special Condition AA of the Generation Licence. This is likely to lead to a widening of bid-offer spreads in the power market which, in turn, is likely to lead to higher costs to customers. Suspension of the MMO materially changes assumptions Ofgem has made in its proposal to reference the mid-point of the bid-offer spread in the default tariff cap and raises questions about the suitability of this proposal.

We recognise that the structure of the electricity market has changed and continues to change; former vertically integrated companies (including E.ON) are focussing on different parts of their value chains. Given the declining number of parties subject to the MMO we agree with Ofgem that the obligation should be reviewed to ensure it works effectively and is funded fairly. However, a need to review the effectiveness and funding of the current MMO in this changing environment should not be confused with conclusions on the effectiveness of market making in the power market overall and is not justification to suspend the obligation. We note that the four parties currently covered by the obligation still represent around 50%¹ of the generation market.

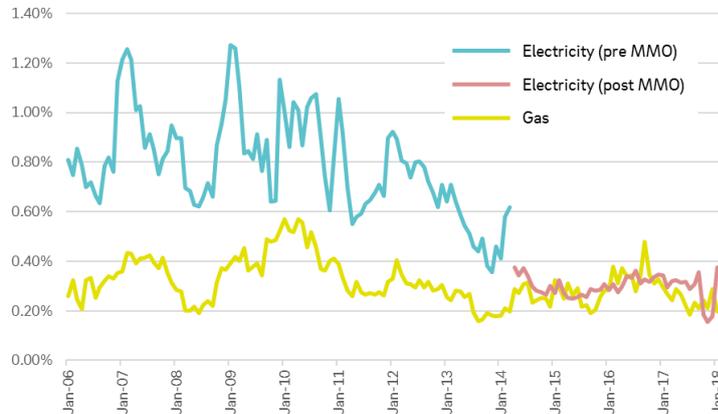
The MMO has delivered a narrow bid-offer spread

As Ofgem has shown in its various publications on the effectiveness of the MMO, the bid-offer spread has narrowed. Figure 1 below, based on Ofgem's data, shows that since the MMO was introduced bid-offer spreads of affected products have narrowed and have consistently been in line with bid-offer spreads for gas:

¹ Ofgem Wholesale Market Indicators: wholesale electricity generation market shares by company in 2017 (GB) Data



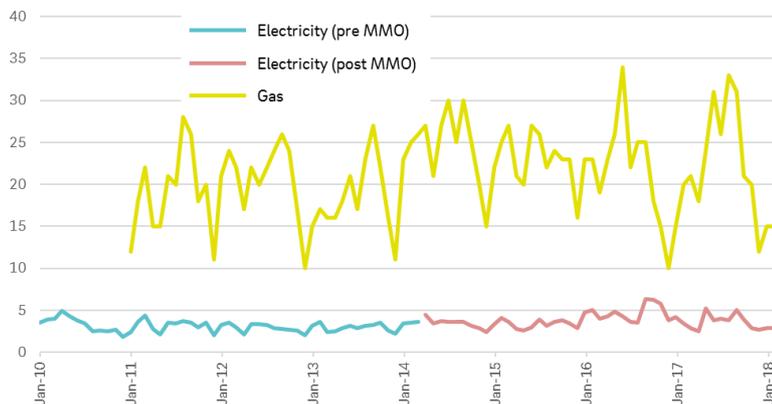
Figure 1: Average² bid-offer spreads of products covered by the MMO³



The MMO has not improved liquidity

Despite its apparent success in narrowing spreads, the underlying level of churn has not improved. Ofgem’s data shows that churn in the electricity market remains much lower than in the gas market and the trend has not changed since the introduction of the MMO. The narrowing of the bid-offer spread shown in Figure 1 has resulted from the limits imposed by the MMO rather than any underlying improvement in liquidity:

Figure 2: Churn rate of electricity and gas⁴



² Average of Front Month, Front Quarter, Front Season, Second Season, Third Season, Fourth Season

³ Ofgem Wholesale Market Indicators: electricity and gas bid-offer spreads by contract type

⁴ Ofgem Wholesale Market Indicators: electricity and gas trading volumes and monthly churn ratio by platform (GB)

Suspending the MMO is likely to widen bid-offer spreads

Given that underlying liquidity has not improved, it follows that suspending the MMO will result in bid-offer spreads returning to the levels seen before the MMO was introduced. Ofgem’s own analysis from July 2017 shows the difference between bid-offer spreads of products covered by the MMO and those not. Following suspension of the obligation we expect spreads of MMO products (solid lines in diagram below) to tend towards spreads of products not covered by the obligation (dotted lines in diagram below).

Figure 3: excerpts from Ofgem’s review of liquidity, July 2017⁵ [arrows added by E.ON]

Figure 7 – Bid-offer spreads on selected baseload products. Source: ICIS

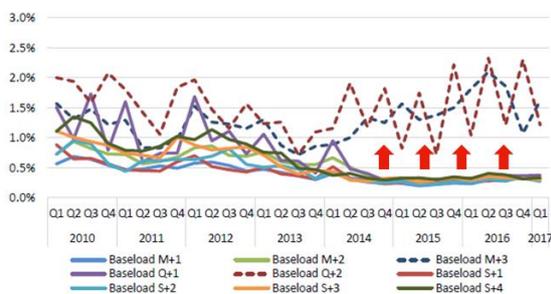
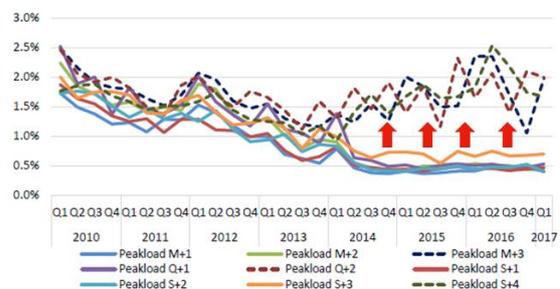


Figure 8 – Bid-offer spreads on selected peakload products. Source: ICIS



Wide bid-offer spreads are likely to increase costs to customers

A wide bid-offer spread means independent suppliers or generators find it more difficult to access the underlying cost or value of electricity. In the case of a supplier buying energy, while offer prices may be available in the market, a wide bid-offer spread indicates these offers may not represent true, underlying value. Suppliers would either have to accept these higher prices on behalf of their customers or delay their purchases until liquidity improves and the bid-offer spread narrows. This will increase a supplier’s costs either directly through buying at prices higher than they would otherwise be, or indirectly as they hold positions longer than they would otherwise, increasing their risk.

We note that some independent suppliers access the market through agreements with third parties that may reference market offers or spreads. These suppliers will also see higher costs as a result of widening bid-offer spreads. The impact of suspending the obligation will not be limited to those parties accessing the market directly.

⁵ Ofgem Secure and Promote Review: Consultation, 25th July 2017



Suspending the MMO has a direct impact on the proposed default tariff cap methodology

Appendix 4 of Ofgem's statutory consultation on the Default Tariff Cap⁶ recognises the importance of the bid-offer spread and the transaction costs that independent market participants face as a result of the spread when buying and selling electricity. Ofgem proposes to use the mid-point of the spread to assess forward electricity prices on the basis that this is a closer indicator of the underlying cost of energy. This assessment has been made based on a market with the MMO in operation; suppliers' comments on the methodology to date have also been based on a market with the MMO in existence. Suspending the MMO is a material change which raises new questions about the use of the mid-point as the forward price reference in the proposed price cap methodology; independent suppliers are less likely to be able to access prices in the market reflecting the mid-point. With a wider bid-offer spread likely to result from suspending the MMO, a reference closer to the offer price is more appropriate.

The possibility of further reductions in the number of obligated parties is not justification to suspend the MMO in advance

For all the reasons given above, suspending the MMO is likely to result in increased costs to customers. We accept that the number of parties covered by the current MMO may reduce further in future. This may justify changes to the MMO and how it is funded, it does not justify suspension of the MMO in advance.

If you have any queries or wish to discuss this response in any more detail, my contact details are provided at the top of this letter.

Yours sincerely,

Steve Davies
Head of Wholesale Market Regulation

⁶ Ofgem Default Tariff Cap: Statutory Consultation, Appendix 4 – Wholesale Costs