Cathryn Scott,
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Ofgem
10 South Colonnade
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London
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20 September 2018

Dear Cathryn

Re: Potential suspension of the Market Making Obligation

I enclose a recent editorial from our weekly *Energy Spectrum* publication in which Cornwall Insight sets out why, in a rapidly changing marketplace, there is the need to draw to a close the regulator's wider review of Secure and Promote (S&P) kicked off last summer before any decision suspending the Market Making Obligation (MMO) is taken.

We have discussed with members of our monthly supplier forums, and other parties including large customers, distributed generation operators, and wholesale market intermediaries, their concerns with Ofgem's proposal to suspend the MMO. We do not purport to represent any party, and our views are our own, but they are shared with many independent parties in the market.

Our key messages are:

- Many independent suppliers rely on the MMO as a key element of their hedging strategy. Suspension of the service, with no formal notice of when this could occur, will detrimentally impact on parties' ability to trade. This is compounded by the introduction of PAR1 and the default price cap this winter. Ofgem noted in its December 2017 *Secure and Promote Review: Consultation on changes to the special licence condition* that "We feel that any significant changes at this point, including the removal of the policy, could jeopardise the support on which some participants rely". This conclusion remains valid today
- Wholesale market access remains a critical requirement in an increasingly competitive supply market, and while we do not dispute market conditions have changed considerably since the MMO was introduced, it is imperative the Ofgem expedite its review of the MMO criteria and other potential mechanisms for delivering market making, and include:
  - whether and how S&P has helped foster market entry and growth, and what role has the Supplier Market Access (SMA) and MMO arrangements separately played in this. What does success look like and when will we know when we get there?

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- are there other market making arrangements that could replace the MMO without placing undue costs on specific players?
- given Ofgem's separate concerns about risky supplier business models, what is a reasonable level of risk management expected of prudent suppliers and does the trading environment facilitate this? If not, what are the distortions and how can they be addressed?
- one notable distortion is credit and collateral costs, for wholesale energy trading and regulated costs too, which are excessive. How can these be rationalised and mitigated?, and
- the recent EBSCR review was a bit of a whitewash. How will the trading arrangements and risks be impacted by marginal cash-out?

We would welcome a meeting to discuss these issues further, and to invite an Ofgem representative to an upcoming supplier forum meeting to inform members of the regulator's position following this call for stakeholders to provide views on this matter.

Yours sincerely

Ed Reed

Head of Research

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Sustaining liquidity in wholesale electricity markets

In a move that has taken many by surprise, Ofgem has suggested it may suspend the Market Making Obligation (MMO) introduced in 2014. The MMO is one of the key elements of Secure and Promote (S&P), the regulator's programme to improve electricity wholesale market access.

In this week's *Energy Perspective* we set out why, in a rapidly changing marketplace, there is the need to draw to a close the wider review of S&P kicked off last summer before Ofgem makes any decision on suspension. In particular, while the vertically-integrated model that underpins the MMO is fast falling away, the S&P arrangements do need to be looked at as a whole as fair wholesale market access remains a critical requirement in an increasingly competitive supply market.

Figure 1: Secure and Promote timeline to date

2008 – Wholesale market liquidity identified as potentially detrimental to retail competition in Energy Supply Probe

March 2009 – Addressing market power concerns in the electricity wholesale sector - Initial policy proposals

June 2009 – Liquidity in the GB wholesale energy markets

February 2010 – Liquidity proposals for the GB wholesale electricity market

July 2010 –GB wholesale electricity market liquidity: summer 2010 assessment

December 2010 – Open letter: Liquidity in the GB power market update and next steps

12 June 2013 – Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition

31 March 2014 – Secure and Promote comes into effect

30 November 2016 – Decision letter on E.ON disapplication request from MMO requirement

25 July 2017 – Secure and Promote review: consultation

13 December 2017 – Secure and Promote review: consultation on changes to the special licence condition

9 August 2018 – Decision letter on Centrica disapplication request from MMO requirement

9 August 2018 – Open letter on suspending MMO

20 September 2018 – Response date on proposal to suspend MMO

Low tide

Following a long period of assessment (Figure 1), Ofgem introduced S&P in April 2014. It aimed to address concerns that levels of liquidity in the wholesale electricity market had been persistently low. This in turn affected the ability of suppliers to hedge their positions.

The MMO was part of a package, and it was originally placed on the generation licences of the Big Six. It mandated that a set of wholesale products were made available. It also defined rules on when the products must be made available, clip sizes, and maximum spreads on prices. Bids (to buy) and offers (to sell) have to be maintained during two trading windows each day (10:30 to 11:30 and 15:30 to 16:30). Rules were also introduced to give protection to MMO parties from price volatility in the trading window.

The Supplier Market Access (SMA) rules, the other main element of S&P, was originally placed on the Big Six but also Engie and Drax. The SMA rules set out the minimum standards that small suppliers should expect when negotiating trading agreements with the large players. They included timely response during negotiations, and provision of fair and transparent credit and collateral terms. There are no indications of an early intent to change this part of the package, or the day-ahead reporting requirements.

Ebb and flow

The regulator undertook to review S&P, a process it commenced in July 2017 with a consultation. Respondents broadly stated that: the policy should be maintained as it had delivered benefits; and some argued the scope should be increased, mainly to support more mandated products. Other respondents noted that the benefits of the

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policy were hard to quantify, but that the policy had created market distortions and significant costs for MMO parties.

In its December 2017 follow-up, Ofgem stated “We feel that any significant changes at this point, including the removal of the policy, could jeopardise the support on which some participants rely”. But it suggested changes to reduce the costs for MMO parties including a soft landing period at the start of the trading window and a new “fast market” rule. It also noted that its more fundamental review would be concluded in 2019.

But in the open letter, dated 9 August, Ofgem said it was not minded to pursue the proposed changes set out in its December 2017 document. Instead it was exempting Centrica from the MMO (following E.ON’s exemption in November 2016) as the company had restructured. A key message was that it agreed that conditions differed sufficiently from those at the time of implementation, and that it no longer had a significant GB electricity generation portfolio. It was therefore no longer appropriate for the company to have an MMO.

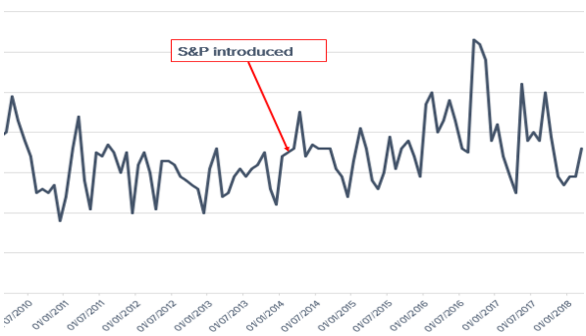
Figure 2: Ofgem’s three liquidity objectives

- Ensure the availability of a range of longer-term products to support hedging of risk of exposure to large changes to prices
- Support robust reference prices that that are widely available to market participants, and
- Promote an effective near-term market which enables all companies to buy the power they need for their customers.

One consequence of this second exemption was that remaining MMO parties will “face disproportionate costs”. and therefore there was a case to suspend the MMO pending completion of the 2019 review. But Ofgem did not address the implications of this change in approach, and it presented no information on the wider competitive benefits the MMO brings, or notably how service users will achieve alternative market access. It does, however, acknowledge that the MMO criteria (that is, who it should apply to) should be addressed “and other potential mechanisms for delivering market making” considered.

Cross currents

Figure 3: Electricity wholesale churn



Source: Ofgem

We have spoken with numerous parties about their views on this important shift in regulatory policy. These include not only a range of suppliers (predominantly recent entrants), but also distributed generation operators, traders, and large customers that purchase electricity via “flex” arrangements. Many parties will be submitting their own responses to the open letter. But these conversations have allowed us to firm up our own views, which we present below.

Referencing Ofgem’s liquidity objectives (Figure 2), there is evidence that trading for longer-term products has materially improved, with a slight increase in the volume of contracts traded.

Churn shows how often a unit of electricity is traded before it is delivered to end consumers, and Ofgem's data is presented in Figure 3. It suggests a 20% increase in churn since S&P was introduced from 3 times to 3.7 times now, but not to the levels that Ofgem argued previously represented a healthy, liquid market.

In practice, the MMO has concentrated daily trading of longer-term products into the two trading windows (Figure 4) and trades outside the windows have actually decreased. But bid offer spreads on mandated products have decreased.

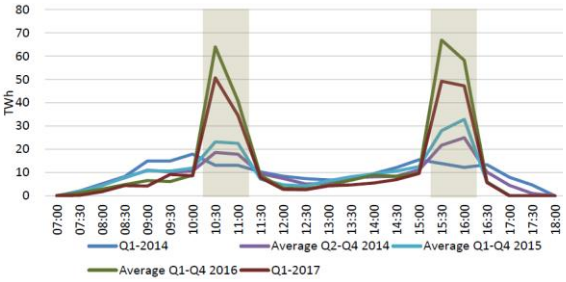
A number of smaller suppliers argue not only for the maintenance of the MMO, but for more granular products to enable more effective hedging. The MMO does not provide the "shape" of products that suppliers require to derive a typical domestic profile down to half-hourly blocks.

If the MMO is suspended, there is little confidence among independent suppliers that trading levels will be maintained. There are also concerns that bid-offer spreads will widen again, exposing parties to higher costs when closing out positions. And, without the MMO, there is real concern that confidence in price discovery will be diminished.

This reversal would occur at a time when domestic suppliers are increasingly operating within a price cap environment. Electricity imbalance prices are also set to become 'sharper' from November. Both these factors will place suppliers under stronger pressures to hedge, so the timing of Ofgem's likely move could appear curious.

Water under the bridge

Figure 4: Trading of OTC forward power contracts through the day, quarterly averages



Source: Ofgem

But Ofgem is on the horns of a dilemma. Market conditions are certainly substantially different to those of the early years of this decade. At the same time the wider lessons that have been learned from S&P suggest trading barriers remain.

Prior to S&P being introduced there were 36 active suppliers across domestic and non-domestic, compared to 106 now operational. Independents accounted for just over 6% of domestic supply, compared to over 23% today. That said, Ofgem has gone on record as saying that it does not attribute the increase to S&P.

On the one hand this context means that a majority of suppliers (by number) have never experienced a market without the S&P intervention. On the other it means that many have developed trading desks or work with trading parties with whom they have established effective relationships.

But it is on the generation side where arguably there have been more dramatic changes. Distributed generation capacity is now above 30GW, and the vertically integrated model (which the CMA did not of itself see as a problem) is visibly breaking down.

There was no threshold for application of the MMO; it was built into the generation licences of the Big Six. Two of them have restructured and the MMO doesn't make sense. With the SSE/npower merger apparently a done deal (see this issue, p 5), the merged entity will not have generation. This would leave EDF Energy and Scottish Power bearing the MMO. And costs are an issue, at around an average of £2.4mn/ year/ licensee implying that market volatility of recent could be pushing costs above Ofgem's baseline level.

At the same time the issues around trading and access are not fundamentally different than they were in 2014. In its 9 August letter on the Centrica disapplication, Ofgem conceded that "the objectives of the S&P licence condition are yet to be fully realised", and that "the condition cannot yet be considered a sustained success."

All at sea

Suspension of the MMO would inevitably alter wholesale trading dynamics. Aside from the impact on liquidity and prices, it will likely require hedging strategies, credit, and risk controls to be revisited. This will be costly and will take time. If it is to proceed, a key issue will be providing users sufficient notice to arrange new routes to hedging.

It would also come at a time when a number of suppliers have encountered trading difficulties, with several business failures. Ofgem is already considering changes to arrangements for supplier entry and exit, and a number of other work-streams are on-going that involve (usually increasing) costs and obligations on suppliers.

The review of wider wholesale market access is therefore timely. But suggesting the removal of the MMO intervention ahead of the review is in contrast to the assiduous process and depth of analysis that was carried out over five years before the decision to implement S&P was taken. It also anticipates a significant corporate merger that has yet to occur. It follows that further disapplication by SSE and npower should be at the point of the transaction, not in advance of it.

Flushing out the issues

Given realistic timescales for the merger, Ofgem should therefore expedite its review. It should set out its timetable and scope urgently, and include:

- whether and how S&P has helped foster market entry and growth, and what role has the SMA and MMO arrangements separately played in this. What does success look like and when will we know when we get there?
- are there other market making arrangements that could replace the MMO without placing undue costs on specific players?
- given Ofgem's separate concerns about risky supplier business models, what is a reasonable level of risk management expected of prudent suppliers and does the trading environment facilitate this? If not, what are the distortions and how can they be addressed?
- one notable distortion is credit and collateral costs, for wholesale energy trading and regulated costs too, which are excessive. How can these be rationalised and mitigated?, and
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Until the work programme is defined and suitable alternative market making arrangements identified (and how they might apply alongside the SMA rules), the MMO should not be suspended.

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