

To all interested stakeholders

Email:

wholesalemarketoperation@ofgem.gov.uk

Date: 30 January 2020

Dear Colleagues,

Update – Liquidity Policy Review: Publication of NERA Economic Consulting Options Assessment Report

Today we have published a report commissioned from NERA Economic Consulting titled '*GB Wholesale Power Market Liquidity: Options Assessment*'¹ which forms part of our liquidity policy review. This letter sets out the approach we expect to follow in coming to a decision on the future of liquidity policy and includes an overview of our analysis of the key liquidity indicators for Q4 2019. It also seeks stakeholder input to gather information on market participants trading experiences following the suspension of the Secure and Promote Market Making Obligation ("MMO").

Background

On 30 May 2019, we published an open letter that set out our intention to undertake an options assessment to evaluate whether intervention to support liquidity in the wholesale electricity market remains in the interests of consumers and, if so, whether the design of the Secure and Promote MMO could be improved upon². In August 2019, we appointed NERA Economic Consulting to conduct the initial stage of this options assessment.

On 14 November 2019, we published our decision to suspend the MMO which took effect on 18 November 2019.³ This followed the release of RWE from the Secure and

¹ https://www.ofgem.gov.uk/system/files/docs/2020/01/nera_report.pdf

² https://www.ofgem.gov.uk/system/files/docs/2019/05/liquidity_-_open_letter_may_2019_.pdf

³ https://www.ofgem.gov.uk/system/files/docs/2019/11/mmo_suspension_decision_letter_2.pdf

Promote MMO Licence Condition on 30 October 2019⁴ and consideration of the responses to our open letter dated 08 October 2019⁵. The reasons for our decision included evidence of increased and disproportionate costs for the two remaining parties following the release of RWE and evidence that the policy had become less effective in meeting its objectives.

The decision letter confirmed that our work to assess the need for further intervention and consider alternatives to the Secure and Promote MMO will continue and that, in the event we consider further intervention to support liquidity to be in consumers' interests, we will consult on a preferred approach.

Liquidity Policy Review

Our liquidity policy review is focused on liquidity in the forward markets. It seeks to assess whether, following the suspension of the Secure and Promote MMO, further intervention is required to meet our first and second liquidity objectives for the electricity wholesale market. These objectives, originally identified in 2013⁶, are that the electricity wholesale market must:

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

To determine whether the market can deliver these objectives and provide participants with sufficient access to a range of products required to compete effectively, we will require a view of the level of liquidity in the absence of intervention. We will then evaluate the market conditions this level of liquidity creates and assess the impact of suspension. To provide the market with sufficient time to adjust and ensure sufficient evidence and data can be gathered, we plan to capture a minimum of 6 months of data before undertaking this assessment.

⁴ <https://www.ofgem.gov.uk/publications-and-updates/request-schedule-b-special-condition-aa-no-longer-have-effect-rwe-generation-plc-s-electricity-generation-licence>

⁵ https://www.ofgem.gov.uk/system/files/docs/2019/10/ofgem_-_secure_promote_open_letter_october_2019_ct.pdf

⁶ https://www.ofgem.gov.uk/sites/default/files/docs/2013/11/wholesale_power_market_liquidity_statutory_consultation_on_the_secure_and_promote_licence_condition.pdf

Q4 2019 Liquidity Indicators

We continue to monitor market liquidity and have now analysed data for the period October - December 2019 (Q4 2019). While it is too soon to assess the impact of suspension on liquidity, our analysis indicates that, for the period in question, liquidity did not significantly deteriorate. However, bid-offer spreads on all products previously subject to the MMO increased and peakload liquidity declined.

Key findings

- Q4 2019 saw the continuation of a benign price environment for gas and power. While prompt liquidity for gas was relatively volatile, prices overall followed a downward trend that was conducive to lower volatility and lower churn.
- Churn fell in Q4 2019 to 3.1, the same level as Q4 2017 but a year-on-year decline from 3.6 in Q4 2018. For December 2019, the first full month following suspension of the MMO, churn rose slightly when compared with December 2017 and 2018 to 2.8. This indicates that liquidity did not significantly deteriorate, with overall trading throughout December not adversely affected by the suspension of the MMO.
- The fall in churn over the quarter was due to a decline in total Over-The-Counter (OTC) traded volumes. Total traded volumes for Q4 2019 were comparable to those in Q4 2017 but below the Q4 average over the last five years. Curve peakload products (Season+2, 3 and 4) and curve baseload products (Season+2 and 3) were particularly affected, as well as Month+2 peakload volumes.
- While the volume of traded baseload products for the quarter remained relatively comparable to Q4 2018, peakload volumes fell with this largely driven by a fall in the later-dated peakload products (including Season +1, 2 and 3). Peakload volumes in Q4 2019 were 54% below the five year Q4 average and 32% down compared to Q3 2019.
- Bid-offer spreads increased in Q4 2019, continuing an upward trend from the previous quarters. Bid-offer spreads increased for the products previously subject to the MMO when compared to the same quarter last year, with some

exceeding the previous limits under the Secure and Promote policy. For example, the Month ahead baseload spread was 0.6% and the peakload Season+3 was 1.35%.⁷

- Overall, times of trades for the quarter follow the same pattern as before suspension of the MMO, with trades still concentrated around the 11am and 4pm. However, trading in December was higher throughout the day when compared to December 2018, with trades less concentrated around the peaks associated with the MMO windows.
- Near term liquidity fell by 17% for Q4 2019 when compared with Q4 2018, continuing a downward trend from the start of 2019. However, exchange volumes, including day ahead volumes, increased over the quarter.

The NERA Report

The report '*GB Wholesale Power Market Liquidity: Options Assessment*' commissioned from NERA Economic Consulting represents the first output from our liquidity review. The report represents a step forward in quantitatively assessing the potential benefits of increased liquidity in the GB wholesale electricity market and considers the options for the design of future policy.

Quantifying the potential benefits of intervention

The key findings of the report, in relation to quantifying the potential benefits of intervention to reduce bid-ask spreads, are informative and will be taken into consideration as we progress with the review. Nonetheless, the report sets out the assumptions that underpin the modelling exercise and advises that the results are interpreted in light of both the assumptions and caveats to the modelling approach. As the modelling is theoretical and has limitations, it is not intended to be a full assessment of the welfare benefits of intervention. Therefore, any decision on further intervention will draw from a comprehensive evidence base. This will include: analysis of liquidity metrics overtime, consideration of the impact of suspension, and stakeholder feedback on the operation and opportunities provided by the market following suspension of the MMO.

⁷ The Secure and Promote MMO mandated maximum bid-offer spreads of: 0.5% for Baseload M+1, M+2, Q+1, S+1, S+2; 0.6% for Baseload S+3 and S+4; 0.7% for Peakload M+1, M+2, Q+1, S+1, S+2 and 1.0% for Peakload S+3.

Future policy design

On 01 October 2019, we held a workshop for all interested stakeholders to discuss the liquidity policy options assessment. At the workshop, and in response to a subsequent survey, stakeholders provided a clear majority view that a tendered approach to market-making was preferable to a re-designed mandatory obligation. Tendering for market-making services was viewed as fairer, more likely to be robust to market changes and less likely to create market distortions.

In response, we asked NERA to prioritise consideration of how a tendered approach to market-making could be designed for the GB power market. The report begins this work by drawing upon international experience and stakeholder feedback to identify and evaluate the key design features of a tender, in particular the potential specification of market-making services and options for auction structure.

In line with our decision to re-scope the NERA report, we will work to consider how a tendered approach to market-making could be developed for the GB wholesale market. We remain committed to working with stakeholders throughout this policy development process and in coming to a decision on further intervention.

Next Steps

We will continue to monitor the market and pay particular attention to peakload liquidity.

To help build a comprehensive evidence base for assessing the need for further intervention, we plan to supplement our monitoring and analysis of liquidity metrics with a quarterly survey designed to gather views from market participants on how trading experiences have changed following suspension of the MMO. The survey questions and additional information are provided at Annex A.

We encourage all interested parties to submit returns covering the period **since suspension of the MMO** to wholesalemarketoperation@ofgem.gov.uk on or by **Thursday 27 February 2020**. This may be followed by further engagement to understand answers provided. If you are interested in participating and require an electronic version of the survey, please contact the email address above.

Yours sincerely,

Tom Corcut

Deputy Director, Wholesale Markets

Annex A: Survey on Market Impacts and Perceptions of Liquidity following the suspension of the Market Making Obligation

Dear interested stakeholders,

Introduction

This survey is the first in a series of quarterly surveys that will be used to gain a wider understanding of market conditions and perceptions of liquidity following the suspension of the Secure and Promote Market Making Obligation ("MMO").

The first return, covering the **first three months of suspension**, should be submitted to wholesalemarketoperation@ofgem.gov.uk on or by **Thursday 27 February 2020**.

It aims to gather information on the operation of the market following suspension of the MMO and how market participants trading experiences have changed. It will be used in conjunction with our monitoring and analysis of liquidity metrics and on-going stakeholder engagement to assess the impact of suspension and inform a decision on whether further intervention to support liquidity in the GB wholesale electricity market is in consumers' interests.

Information gathered will be used by Ofgem to support the development of our liquidity policy. Data will be kept for up to 18 months and will be stored on a secure network drive.

Instructions

This survey includes a combination of rating scales and open questions asking you to explain your responses. Please consider and answer each question below and when asked, provide as much information or supporting evidence as possible.

We are seeking survey returns on a quarterly basis. To enable the identification of changes over time, we ask that the views and experiences captured are from the same individual(s) within each company. While this requires survey returns to identify respondents by company name, publication of any analysis will be anonymised.

If you have any questions or would like to receive a copy of the survey via email,
please contact: wholesalemarketoperation@ofgem.gov.uk

Many thanks

Survey Questions

Please consider the period since suspension of the MMO on 18 November 2019.

Q1.a At what time of day do bid/offers usually cover the screen? (***Please check all that apply***)

Early or mid-morning	<input type="checkbox"/>
Mid-morning to early afternoon	<input type="checkbox"/>
Late afternoon (15:30 to market close)	<input type="checkbox"/>
Throughout the day	<input type="checkbox"/>
Not sure	<input type="checkbox"/>

Please provide an explanation about why you've given these responses and any supporting information or evidence for your response.

Q1.b At what time of the day do trading deals typically take place? (***Please check all that apply***)

Early or mid-morning	<input type="checkbox"/>
Mid-morning to early afternoon	<input type="checkbox"/>
Late afternoon (15:30 to market close)	<input type="checkbox"/>
Throughout the day	<input type="checkbox"/>
Not sure	<input type="checkbox"/>

Please provide an explanation about why you've given these responses and any supporting information or evidence for your response.

Next we have series of questions that ask you to provide a rating and then an explanation of the rating. We would like you to consider the **operation of the market since suspension of the MMO and the impact on your organisation.**

Q2. Are you satisfied with the availability of bid-ask spreads in the market?		Not Satisfied	Indifferent	Fairly Satisfied	Very Satisfied	Don't know
a	For baseload products	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
b	For peakload products	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Please provide an explanation about why you've given these responses and any supporting information or evidence for your response.						

		Very Negative	Slightly Negative	No impact	Slightly Positive	Very Positive	Don't know
Q2.c	Given your response above, what impact has this had on your trading activities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Please provide an explanation about why you've given that response and any supporting information or evidence for your response							

To what extent do you agree or disagree with the following statements?		Strongly disagree	Disagree	Neutral / Indifferent	Agree	Strongly agree	Don't know
Q3.	The current market offers a reasonable level of liquidity at times when I need to trade.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Please provide an explanation about why you've given that response and any supporting information or evidence for your response							
Q4.	The current market offers a reasonable level of price discovery at times when I need to trade.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Please provide an explanation about why you've given that response and any supporting information or evidence for your response							
Q5.	Overall, the current market structure provides me with sufficient market access to carry out my wholesale trading activities.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Please provide an explanation about why you've given that response and any supporting information or evidence for your response							
Q6.	I preferred it when trading was compressed into two hour long windows.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Please provide an explanation about why you've given that response and any supporting information or evidence for your response							
Q7	Hedging has cost more since suspension of the MMO.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Please provide an explanation about why you've given that response and any supporting information or evidence for your response							

Q8c. Which of the following products have become easier or more difficult to trade?

	Easier	More difficult	No change	Don't know
Baseload Month +1	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Baseload Month +2	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Baseload Quarter +1	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Baseload Season +1	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Baseload Season +2	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Baseload Season +3	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Baseload Season +4	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Peak Month +1	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Peak Month +2	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Peak Quarter +1	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Peak Season +1	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Peak Season +2	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Peak Season +3	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Q8b. What are the reasons why it has been easier or more difficult to transact?

Q8c. Are there other products that support hedging that you are finding it hard to trade in?