

To all stakeholders

Email:

[wholesalemarketoperation@ofgem.gov.uk](mailto:wholesalemarketoperation@ofgem.gov.uk)

Date: 01 December 2020

Dear colleagues,

### **Update on the future of liquidity policy**

On 30<sup>th</sup> January 2020 we published an update on our liquidity policy review<sup>1</sup>, including the publication of the NERA Economic Consulting Options Assessment report<sup>2</sup>. In that update we set out the approach we would take in making a decision on the future of liquidity policy. Today we are providing an update on liquidity policy and include an overview of our analysis and findings as a result of our market monitoring.

We do not consider that the current evidence demonstrates a prolonged deterioration of liquidity to a level that would result in a net consumer benefit from intervention. Therefore, we are not intervening to support liquidity at this time. We will continue to monitor liquidity indicators and engage with stakeholders.

### **Background**

On 30 May 2019<sup>3</sup>, we published an open letter that set out our intention to undertake an options assessment. This evaluated 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 (S&P) Market Making Obligation (MMO) should be reformed or replaced. In August 2019, we appointed NERA Economic Consulting to conduct the initial stage of this options assessment.

On 14 November 2019<sup>4</sup>, we published our decision to suspend the MMO which took effect on 18 November 2019. This followed the release of RWE from the Secure and Promote MMO Licence Condition on 30 October 2019<sup>5</sup> and consideration of the responses to our open letter dated 08 October 2019<sup>6</sup>.

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<sup>1</sup> [https://www.ofgem.gov.uk/system/files/docs/2020/01/liquidity\\_policy\\_review\\_update\\_january\\_2020.pdf](https://www.ofgem.gov.uk/system/files/docs/2020/01/liquidity_policy_review_update_january_2020.pdf)

<sup>2</sup> [https://www.ofgem.gov.uk/system/files/docs/2020/01/nera\\_report.pdf](https://www.ofgem.gov.uk/system/files/docs/2020/01/nera_report.pdf)

<sup>3</sup> [https://www.ofgem.gov.uk/system/files/docs/2019/05/liquidity\\_-\\_open\\_letter\\_may\\_2019\\_.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/05/liquidity_-_open_letter_may_2019_.pdf)

<sup>4</sup> [https://www.ofgem.gov.uk/system/files/docs/2019/11/mmo\\_suspension\\_decision\\_letter\\_2.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/11/mmo_suspension_decision_letter_2.pdf)

<sup>5</sup> [https://www.ofgem.gov.uk/system/files/docs/2019/10/rwe\\_schedule\\_b\\_decision\\_2.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/10/rwe_schedule_b_decision_2.pdf)

<sup>6</sup> [https://www.ofgem.gov.uk/system/files/docs/2019/10/ofgem\\_-\\_secure\\_promote\\_open\\_letter\\_october\\_2019\\_ct.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/10/ofgem_-_secure_promote_open_letter_october_2019_ct.pdf)

Our liquidity policy review was focused on liquidity in the forward markets. It sought 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 2013, 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.

### **Market monitoring**

We continue to monitor market liquidity and have analysed data for the period up to October 2020. Our analysis indicates that since the suspension of the MMO and more recently the Coronavirus<sup>7</sup> (COVID), total brokered trading has slightly fallen, with peakload trading deteriorating more than baseload trading. Several graphs which helped to form part of our analysis can be found in Annex A.

#### Key findings

- Following on from the trend at the end of 2019, we saw a continuation of a benign price environment for gas and power in Q1 2020. Prices overall followed a downward trend given relatively weak demand and strong supply in Q1 2020, and this trend continued through to June 2020 once demand fell after the first lockdown in March.
- Despite lower demand, average churn (January to August 2020) is 3.7, the same as the previous year. Despite a fall in over the counter (OTC) traded volumes in late summer, this indicator suggests that liquidity did not significantly deteriorate. Overall trading has only been slightly adversely affected by the suspension of the MMO and the effects of COVID. The relative stability of churn year to date reflects sustained trade in the first half of the year, which in addition to relatively higher trade in the exchanges, compensated for a fall in total OTC volumes since July.<sup>8</sup> For example, we note that churn increased year on year in Q2 2020 to 4.1 vs 3.7 in Q2 2019.
- Total OTC traded volumes, for all load profiles, for year-to-date January to October 2020, were 9% lower compared to same period last year. Traded volumes until July remained very similar to the same period in 2019 before significant reductions in August and September. The volumes of both baseload and peakload products for the year-to-date have fallen compared to 2019, however peakload volumes have fallen proportionately more (8% vs 31%). Seasonal baseload products (season (S) +1, 2, and 4) as well as the front month and quarter products all fell year on year, while peakload products have been

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<sup>7</sup> "Coronavirus" means severe acute respiratory syndrome coronavirus 2

<sup>8</sup> Figure 1 in Annex A shows monthly churn, alongside brokered and exchange traded volumes since January 2019.

particularly affected along the curve (month (M)+1, 2, quarter (Q)+1, 2, and S+1, 2, 3).<sup>9</sup>

- Bid-offer spreads on average have increased year on year, continuing an upward trend from 2019. As expected, bid-offer spreads increased for the products previously subject to the MMO when compared to the same period last year; all now exceed the previous limits under the Secure and Promote policy. For example, the month ahead baseload spread was 1.00% on average and the peakload S+3 was 1.82%. The front season baseload products have seen the smallest increase in spreads.
- Overall, times of trades have changed from being concentrated around the 11 am and 4 pm times, to being more evenly spread out along the day with trades less concentrated around the peaks associated with the MMO windows.<sup>10</sup> Near term (day ahead and prompt) volumes have risen when compared with 2019, in line with growing renewable generation capacity

### Stakeholder feedback

We are also interested in stakeholder feedback, and have analysed the responses to our quarterly survey on market impacts and perceptions of liquidity following the suspension of the MMO. These responses cover the period March to May 2020. The 12 responses to the survey indicate that liquidity on baseload products have been materially unaffected, however trading on peakload has deteriorated. In addition, a subset of the respondents provided updated views orally in bilateral meetings this quarter (Q4 2020).

#### Key findings

- Responses showed that spreads on baseloads products were not a concern. Ten respondents were at least 'fairly satisfied' with the availability of bid/offer spreads for baseload products.
- There has been a decline in peakload trading. Five respondents were 'not satisfied' with peakload bid/offer spreads, however this is a decrease from six in the previous quarter.
- Opinion on the impact of suspension on trading activities was split, with five viewing suspension as having a positive impact on trading, three reporting no impact and four reporting a slightly negative impact.
- Six respondents felt there was a reasonable level of price discovery. However four respondents disagreed, with one respondent stating there was no market depth sufficient for price discovery in peak products. One respondents presented a neutral response.
- This response was similar when asked about the current market structure. Seven respondents believed that the market structure was sufficient for market access, but three respondents reported low availability of peakload and

<sup>9</sup> Figures 3 and 4 in Annex A respectively outline the total OTC traded volumes for peakload and baseload key products since January 2019.

<sup>10</sup> Figure 7 in Annex A highlights times of OTC trading pre-suspension and now, by volume

electricity forward agreement (EFA) blocks needed to hedge retail customer's demand profile. Two respondents presented a neutral response.

- All respondents noted that trading was now spread throughout the day, with nine of 12 respondents preferring this.
- Respondents see increased uncertainty in the market related to the end of day-ahead market coupling, with day-ahead liquidity at risk of falling in 2021. This is in addition to uncertainty associated with COVID and future carbon allowance prices. Respondents noted these factors as potential causes to the decrease in traded volumes seen at the end of summer.

## Assessment

To help build a comprehensive evidence base for assessing the need for further intervention, we supplemented our monitoring and analysis of liquidity metrics with a regular survey designed to gather views from market participants on how trading experiences have changed following suspension of the MMO.

In their report, NERA concluded that there was not necessarily a market failure leading to a lack of liquidity in the GB wholesale electricity market but liquidity is lower in GB when compared with other markets in Europe. NERA stated that this may infer underlying market failures which dampen liquidity in GB and as a result, the lack of a distinguishable market failure may not necessarily preclude further intervention.<sup>11</sup>

NERA assumed the effect of intervention through a MMO would reduce bid/offer spreads, which would lower transaction costs, and as a result suppliers and generators would change their optimal hedging strategy and lower their costs of hedging. Through their modelling, they concluded that there would be a net benefit from intervention if liquidity, in the absence of intervention, fell to the low liquidity counterfactual spreads.<sup>12</sup> The low liquidity counterfactual spreads were defined as 1.98% for baseload products and 2.80% for peakload products.<sup>13</sup>

The modelling is theoretical and has limitations. It was not intended to be a full assessment of the welfare benefits of intervention. Therefore, we have drawn from a comprehensive evidence base including analysis of liquidity metrics over time, consideration of the impact of suspension, and stakeholder feedback on the operation and opportunities provided by the market. We have assessed this evidence against NERA's options assessment and our liquidity objectives for the electricity wholesale market, to determine if further intervention is needed.

### Availability of products

We have not seen a material decline in liquidity on longer-term products. Aggregated traded volume on baseload S+3 for year-to-date was 60TWh, compared with 62TWh for the identical period in 2019. Similarly, aggregated traded volume on baseload S+4 was 32TWh, compared with 37TWh for the same aforementioned period in 2019. Further, baseload curve (long-term) products, for example S+5, S+6, and S+7, have higher traded volumes year on year.

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<sup>11</sup> [https://www.ofgem.gov.uk/system/files/docs/2020/01/nera\\_report.pdf](https://www.ofgem.gov.uk/system/files/docs/2020/01/nera_report.pdf), p i

<sup>12</sup> [https://www.ofgem.gov.uk/system/files/docs/2020/01/nera\\_report.pdf](https://www.ofgem.gov.uk/system/files/docs/2020/01/nera_report.pdf), p48

<sup>13</sup> [https://www.ofgem.gov.uk/system/files/docs/2020/01/nera\\_report.pdf](https://www.ofgem.gov.uk/system/files/docs/2020/01/nera_report.pdf) p ii

Longer-term peakload products show a mixed picture. S+3 volumes fell 24% year-to-date, while S+4 rose 18%; liquidity continued to remain low for peakload products after and including S+5. We note however, that nearer term volumes (S+1, S+2) for both baseload and peakload have fallen, and particularly so for peakload (28% less for peakload vs 9% less for baseload).

Since the suspension of S&P, monthly bid/offer spreads on baseload S+1, S+2 and S+3 have consistently been below the historical (2009-2013) spreads. The majority of baseload S+4 monthly bid/offer spreads have also been below the historical spreads threshold. However, the vast majority year-to-date baseload bid/offer spreads on the front months and Q+1 have been above the historical spreads.

Traded volumes have clearly declined and there has been an increase in bid/offer spreads on longer-term peakload products, however overall traded volumes on baseload season products have stayed almost stable.<sup>14</sup> The year-to-date total traded volumes of all seasonal products, up to and including October 2020 is 397TWh, compared to 418TWh over the same period in 2019.

Despite this fall we do not consider that there has been a substantial decline in traded volumes of longer-term products, however we will continue to monitor this closely.

#### Reference prices available to market participants

We have been monitoring bid/offer spreads on a monthly basis since the suspension of the MMO and have compared these to counterfactual liquidity levels assessed by NERA.<sup>15</sup>

Bid/offer spreads only increased above the low liquidity threshold<sup>16</sup> for three out of the 13 market making products<sup>17</sup> since the S&P suspension. These were –

- Baseload Q+1, which rose to 2.06% and 2.15% in February and March 20,
- Peakload M+2, which rose to 2.98% and 2.89% in May and June 20,
- Peakload Q+1, which rose to 2.92%, 2.83% and 2.85% in March, May and June 20.<sup>18</sup>

Bid/offer spreads for these products were only above the low liquidity threshold for a limited time. Spreads for these products decreased in July and August 20 and are no longer above the low liquidity threshold, demonstrating that the increase in spreads is not a continuous trend.

As NERA stated, based on the theoretical model there would be a net benefit to intervention if bid/offer spreads fell to the low liquidity counterfactual spreads. We do not consider the evidence demonstrates the current situation to be a prolonged

<sup>14</sup> Figure 2 in Annex A shows the total OTC baseload traded volume since January 2019.

<sup>15</sup> Figures 5 and 6 in Annex A outline monthly average bid-offer spreads for baseload and peakload key products since January 2019.

<sup>16</sup> The NERA low liquidity counterfactual spreads were defined as 1.98% for baseload products and 2.80% for peakload products.

<sup>17</sup>

	Products						
Baseload	M+1	M+2	Q+1	S+1	S+2	S+3	S+4
Peakload	M+1	M+2	Q+1	S+1	S+2	S+3	

<sup>18</sup> Calculated as monthly averages

deterioration of liquidity to a level that requires intervention. Although some traders have expressed difficulty accessing peakload products, with wider spreads, we have concluded that liquidity has not significantly deteriorated overall.

### **Conclusion**

Having assessed our comprehensive evidence base in relation to the S&P policy review, we consider that liquidity has not fallen to a level whereby our liquidity objectives are not being met by market conditions. We do not believe that intervention is currently justified. Therefore, we are not intending to develop policy options at this time.

### **Next steps**

We will continue to monitor liquidity in the electricity market through our regular market monitoring. We will also supplement this monitoring and our analysis of liquidity metrics by assessing how trading experiences have changed following suspension of the MMO. As such, we would welcome responses to the survey covering Q3 and Q4 2020 provided in Annex B. Furthermore we aim to issue a subsequent survey in Q1 2021, following the end of the transition period.

We remain committed to engaging with stakeholders on the efficacy of the wholesale market arrangements.

If you have any questions please contact [wholesalemarketoperation@ofgem.gov.uk](mailto:wholesalemarketoperation@ofgem.gov.uk).

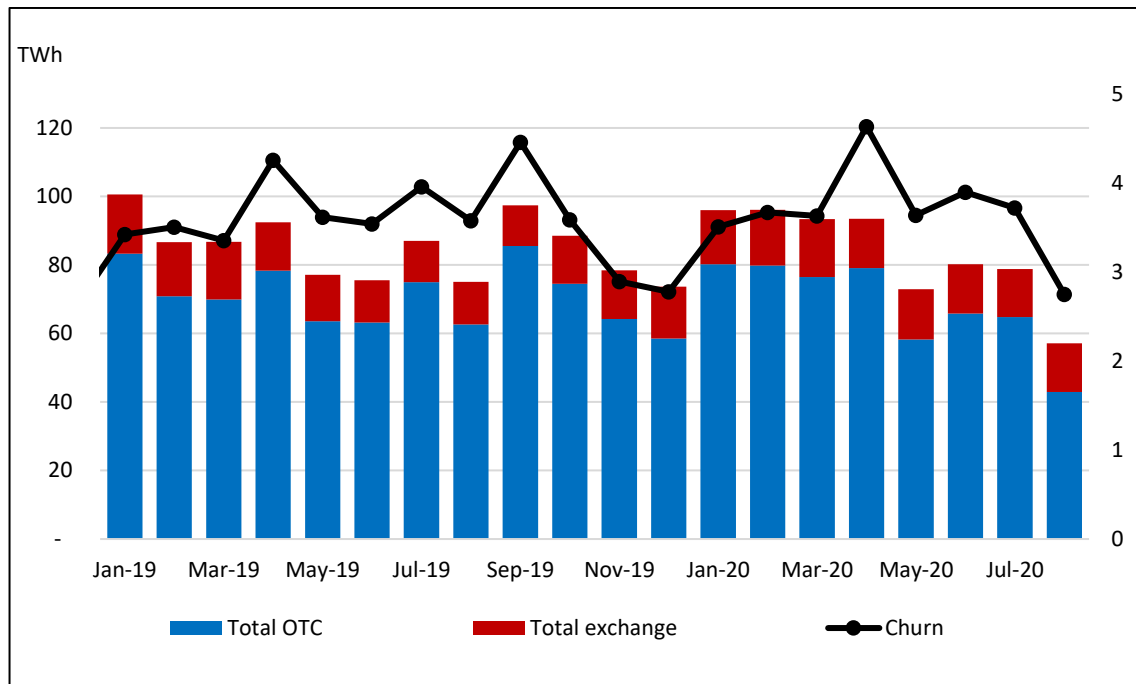
Yours sincerely,

**Tom Corcut**

**Deputy Director, Wholesale Markets**

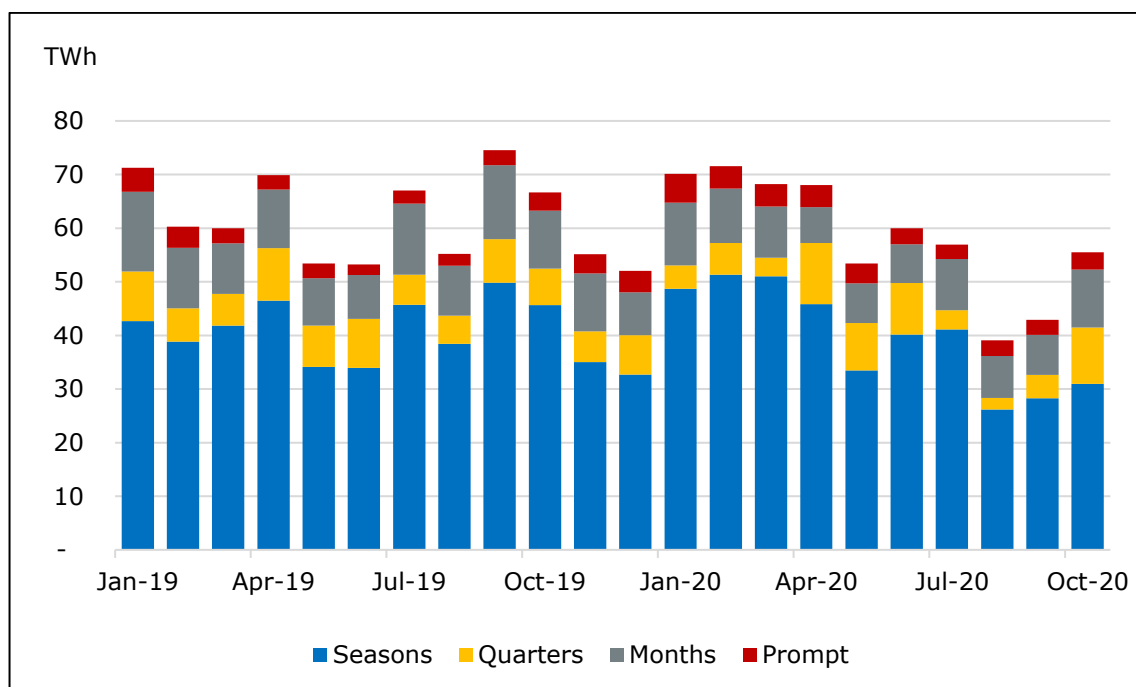
### Annex A: Supporting graphs

Figure 1: Monthly churn (right-hand side axis) and brokered + exchange traded volumes (left-hand side axis) since January 2019



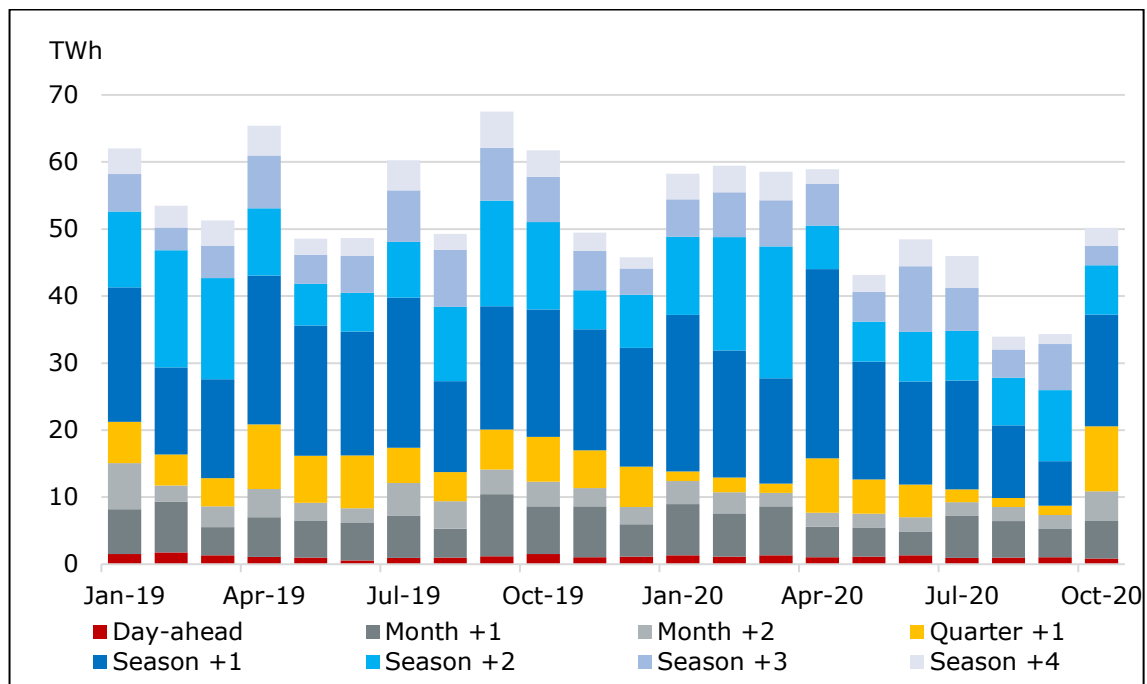
Source: Nord Pool, EPEX SPOT, ICIS, BEIS

Figure 2: Total OTC baseload traded volume since January 2019



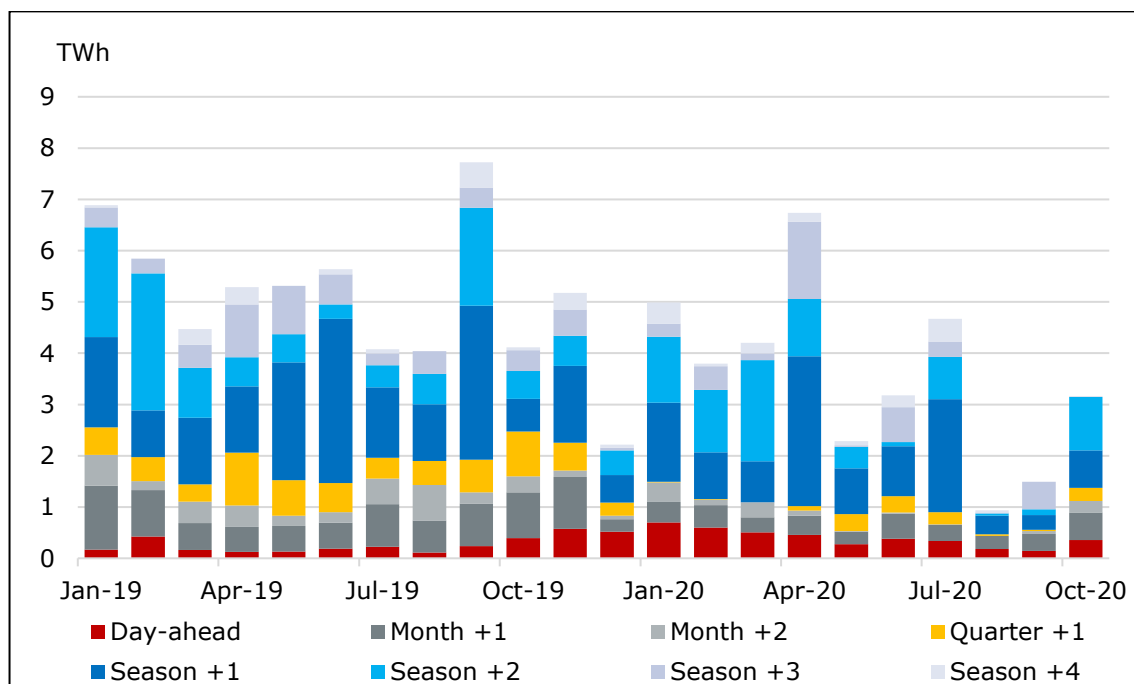
Source: ICIS

Figure 3: Total OTC baseload traded volumes by key product since January 2019



Source: ICIS

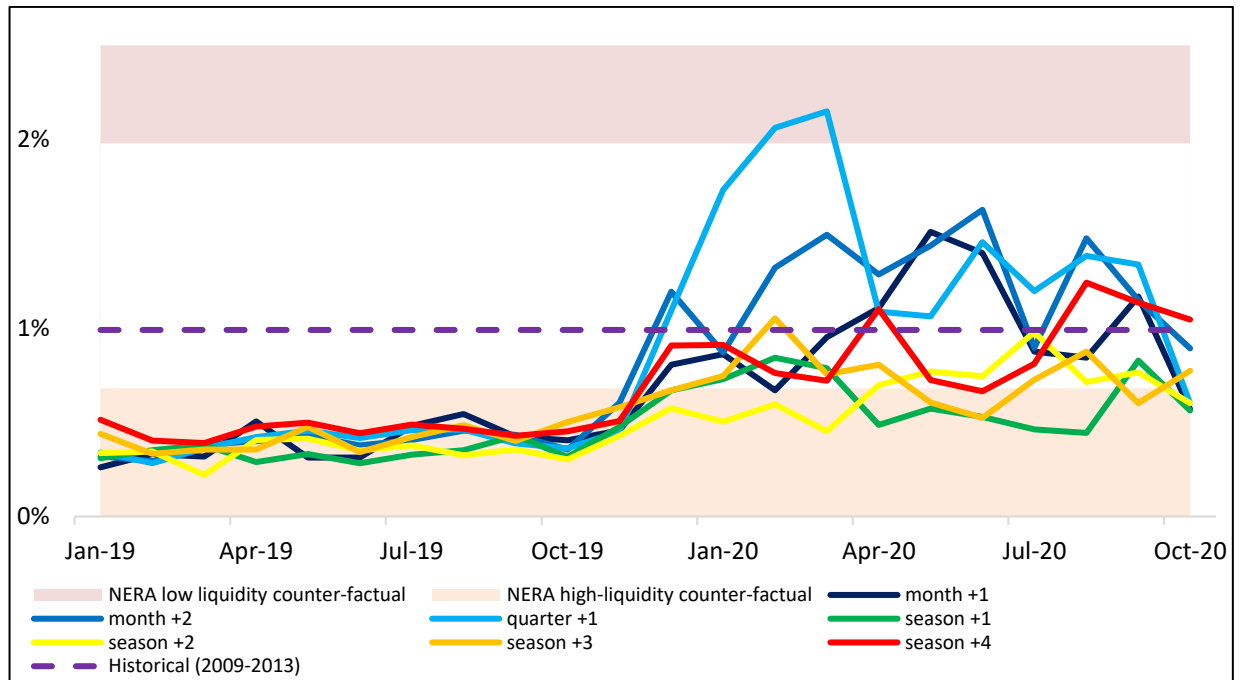
Figure 4: Total OTC peakload traded volumes by key product since January 2019



Source: ICIS

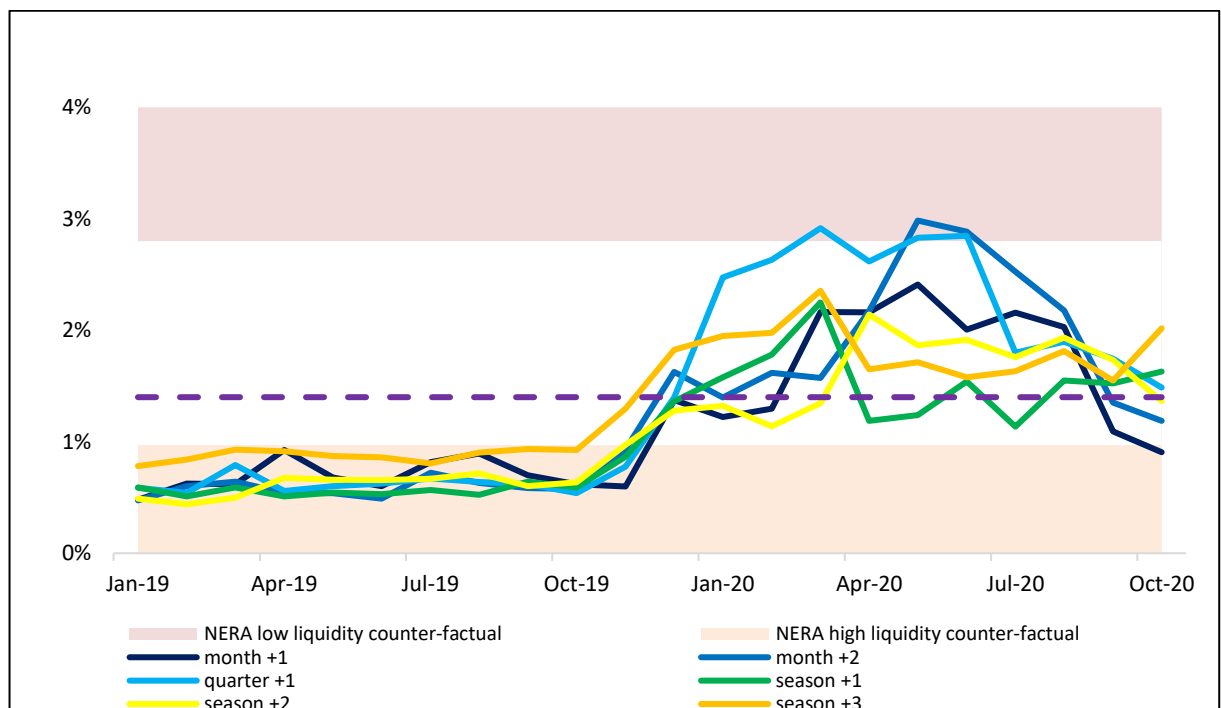


Figure 5: Monthly average bid-offer spreads (%) for baseload by key product since January 2019



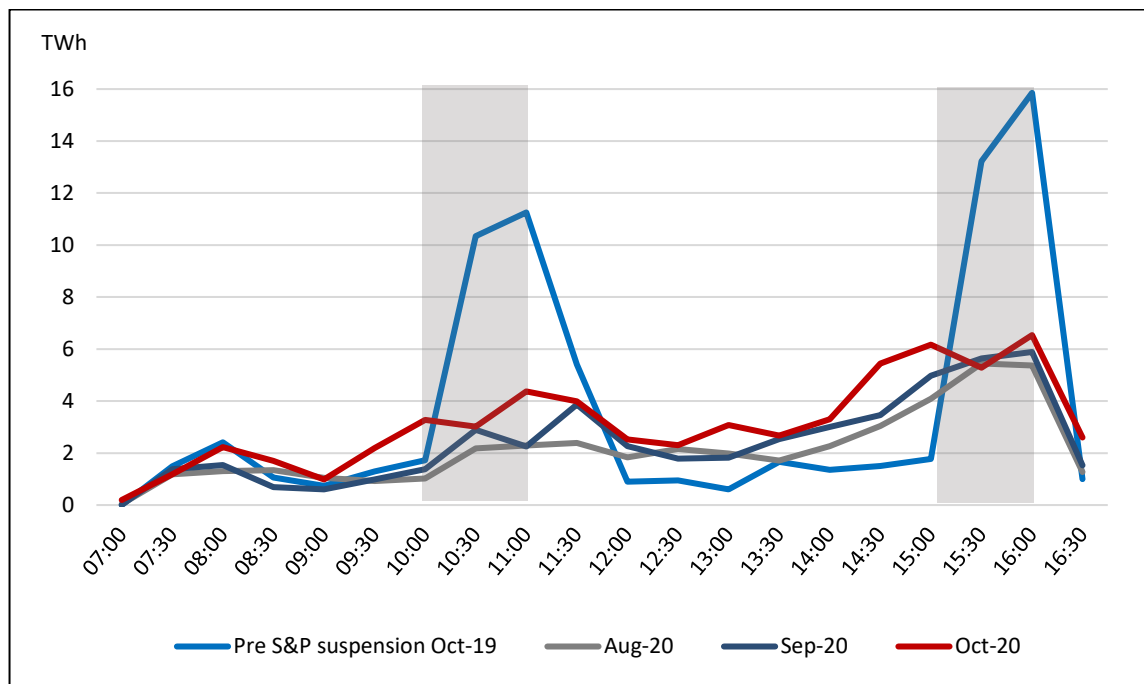
Source: ICIS

Figure 6: Monthly average bid-offer spreads (%) for peakload by key product since January 2019



Source: ICIS

Figure 7: Times of OTC trading pre-suspension and now by volume



Source: ICIS

## **Annex B: Survey on Market Impacts and Perceptions of Liquidity following the suspension of the Market Making Obligation**

Dear interested stakeholders,

### **Introduction**

This survey follows 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").

Responses, covering **Q3 and Q4 2020**, should be submitted to [wholesalemarketoperation@ofgem.gov.uk](mailto:wholesalemarketoperation@ofgem.gov.uk) on or by **Wednesday 30 December 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.

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](mailto: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?		<b>Not Satisfied</b>	<b>Indifferent</b>	<b>Fairly Satisfied</b>	<b>Very Satisfied</b>	<b>Don't know</b>
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"/>
<b>Please provide an explanation about why you've given these responses and any supporting information or evidence for your response.</b>						

		<b>Very Negative</b>	<b>Slightly Negative</b>	<b>No impact</b>	<b>Slightly Positive</b>	<b>Very Positive</b>	<b>Don't know</b>
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"/>
<b>Please provide an explanation about why you've given that response and any supporting information or evidence for your response</b>							

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"/>
<b>Please provide an explanation about why you've given that response and any supporting information or evidence for your response</b>							
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"/>
<b>Please provide an explanation about why you've given that response and any supporting information or evidence for your response</b>							
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"/>
<b>Please provide an explanation about why you've given that response and any supporting information or evidence for your response</b>							
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"/>
<b>Please provide an explanation about why you've given that response and any supporting information or evidence for your response</b>							
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"/>
<b>Please provide an explanation about why you've given that response and any supporting information or evidence for your response</b>							

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

	<b>Easier</b>	<b>More difficult</b>	<b>No change</b>	<b>Don't know</b>
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?