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Secure and Promote Review: Response to Consultation

Dear Matthew and Hannah,

RWE welcomes the opportunity to respond to the Ofgem consultation on the Secure and Promote Review.

Ofgem should remove the market-making obligation (MMO) and reduce the scope of the Supplier Market Access (SMA) rules. If Ofgem seeks to maintain mandatory market making, the obligation should be removed from the five obligated parties and Ofgem should tender for one or more mandatory market makers and socialise the costs across all retailers. At the same time, the obligation should be broadened to cover two two-hour windows with new market makers guaranteeing to provide regulated spreads for at least 60 minutes during each window. In this way Ofgem could secure the same level of obligation while significantly reducing the cost to consumers of meeting the obligation.

The original purpose of Secure and Promote was to improve independent suppliers' access to the wholesale market at a time when there was concern about their ability to compete in the retail market. The successful entry of many smaller suppliers to the market in recent years and the declining market shares of the large suppliers strongly suggests that access to the wholesale market is not a significant problem for suppliers. The set of liquid wholesale market products has also been constant both before and during the policy, which suggests that smaller suppliers continue to have access to the products they need to manage their risks.

Smaller suppliers' success would also appear to be despite the Secure and Promote (S&P) policy rather than because of it. There is no concrete evidence to suggest that MMO has improved liquidity when compared to the years before the obligation and volumes actually fell in 2015. Market fundamentals continue to provide a better explanation of the drop off in liquidity from 2009 to 2013 and the increase in volatility and volumes in 2016. At the same time, there is clear and unequivocal evidence that the MMO has distorted the pattern of trade as liquidity has concentrated in the obligation windows. As a consequence, the MMO has reduced the availability of genuine liquidity throughout the day and increased barriers to the entry of new wholesale market participants.

Secure and Promote continues to require five market participants to cross-subsidise their competitors' risk management activity at an annual cost of some £20 million without due reason. Since the introduction of the obligation, the CMA has also concluded that "we have not identified any areas in which vertical integration is likely to have a detrimental impact on competition for independent suppliers and generators. …"[1] This undermines the very basis of an obligation imposed on the generation affiliates of the larger suppliers precisely because they are deemed vertically integrated. Not only were the original criteria for selecting the obligated parties arbitrary and discriminatory, they are now also increasingly anachronistic in a world where two of the obligated parties have divested their retail businesses and other major generators have acquired retail businesses but not become subject to the obligation. At best, the foundations of the obligation are not fit for a future which may see further restructuring and further reductions in the number of obligated parties.

If Ofgem seeks to maintain mandatory market making, the obligation should be removed from the five remaining obligated parties. Ofgem should tender for one or more mandatory market makers and socialise the costs across all retailers.

Ofgem can also significantly reduce the cost of market-making obligation by extending the windows to two hours each with a guarantee to maintain mandatory spreads for at least 60 minutes within each window. This would allow Ofgem to maintain the level of the obligation both in duration and volume, while removing the distorting concentration of liquidity with the narrow one hour windows and the artificial churn of volumes between the obligated parties at times of price volatility. Wider windows will increase liquidity and the robustness of prices for a larger part of the trading day.

While the SMA rules on "Request for Trading Agreement" rule may have made it easier for smaller suppliers to access the market, small suppliers largely bypass the "Request to Trade" provisions when executing their hedges. This suggests that the "Request to Trade" provisions are no longer required and should be removed.

If you have any comments or wish to discuss the contents of this letter then please do not hesitate to contact me.

Yours sincerely,

Paul Dawson

[1] Paragraph 90, "Energy Market Investigation: Summary of Final Report", Competition and Markets Authority, June 2016.

Annex 1: RWE Response to the Consultation Questions

Question 1: Please comment on whether you think prices for forward delivery are robust. Please refer to prices in and out of the market making windows and comment on the current mandated bid-offer spreads.

Prices for forward delivery are robust. As Ofgem's analysis highlights, market spreads for the mandated products are all suitably narrow.

We would question Ofgem's conclusion that spreads would generally widen in the absence of the market making obligation (MMO) based on recent evidence of slightly wider spreads in non-mandated products.[2] While spreads in non-mandated products show some increases over the course of 2016, this is a natural response to the increased price volatility in that year and there is little discernible trend otherwise. Moreover, the non-mandated spreads shown were actually lower in 2013 before the obligation was imposed. The conclusion therefore, is not that spreads generally would be higher were the obligation removed or relaxed, but that the MMO serves to maintain spreads at artificially low levels at times of significant price volatility.

Question 2: Please comment on whether the windows promote greater availability of products needed to hedge. Please provide evidence you may have on the availability of products outside the windows.

We note Ofgem's conclusion that there has been slight increases in the volumes of all contracts traded and increases in further dated products – particularly peak-load products – since the introduction of Secure and Promote. The wide availability of products needed for hedging purposes has therefore been maintained under the policy.

The most notable and concerning impact of the MMO, has been the concentration of trade within the market-making windows. As Figure 1 illustrates, while 80% of trade was historically outside the windows that position has been reversed with only 20% of trades now typically taking place outside the windows. During the last quarter of 2016, a mere 10% of volumes were struck outside the windows.

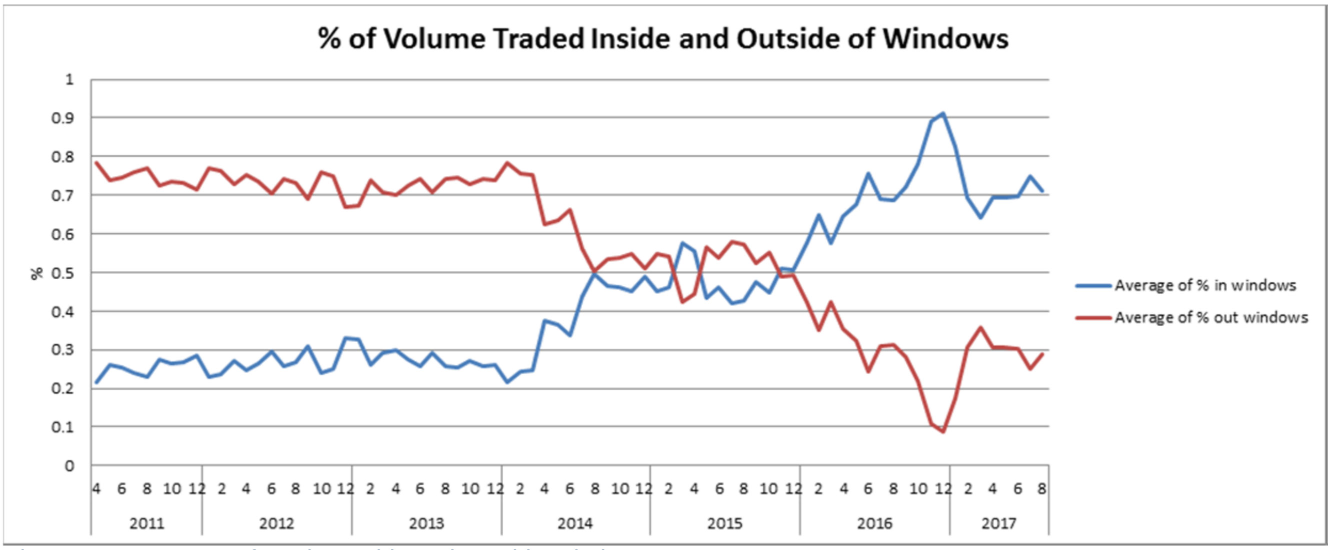

Figure 1: Percentage of Trades Inside and Outside Windows

[2] Paragraph 1.11, "Secure and Promote Consultation", Ofgem, July 2017.

The concentration of volumes in the windows has often resulted in very poor liquidity outside the windows in both mandated and non-mandated products.

While products which facilitate longer-term hedging (eg, beyond 2 or more years) and or tailored hedging of shape (weekday 5 and 6) remain relatively illiquid, this reflects the underlying structure and risks of the GB electricity market and the liquid tenors in the UK gas market.

Question 3: What are your views on how liquid the near-term market is? Please refer to any factors that you consider have contributed to the liquidity of the near-term market.

The near-term markets are sufficiently liquid. The coupled day-ahead auctions provide reliable and robust day-ahead prices. These day-ahead price references provide the basis for the development of financial forward and futures contracts, which would reduce barriers to the entry of new financial market participants. While liquidity in these contracts is yet to develop significantly in GB, the presence of the day-ahead coupled auctions is the bedrock for forward market liquidity in the Nordic and German hubs.

Question 4: What are your views on our high-level analysis of the state of liquidity? Are there any factors not identified that we need to consider to assess liquidity or Secure and Promote? Please provide quantitative or qualitative evidence where relevant.

While Ofgem highlights increased volumes from 2014 as a possible indication of the success of the policy, with the exception of 2016, total market volumes actually show little discernible change over the past 10 years (Figure 1). The fall in volumes between 2009 and 2013 resulted from the exit of the banks from the commodity markets in response to the financial crisis and the more stringent prudential regulation that followed. While volumes have recovered to levels seen in 2008/09 since, it's difficult to attribute this to S&P alone and 2015 actually showed lower volumes than 2014 despite covering a complete rather than partial year of the MMO. Increased price volatility also largely explains the 2016 increases.

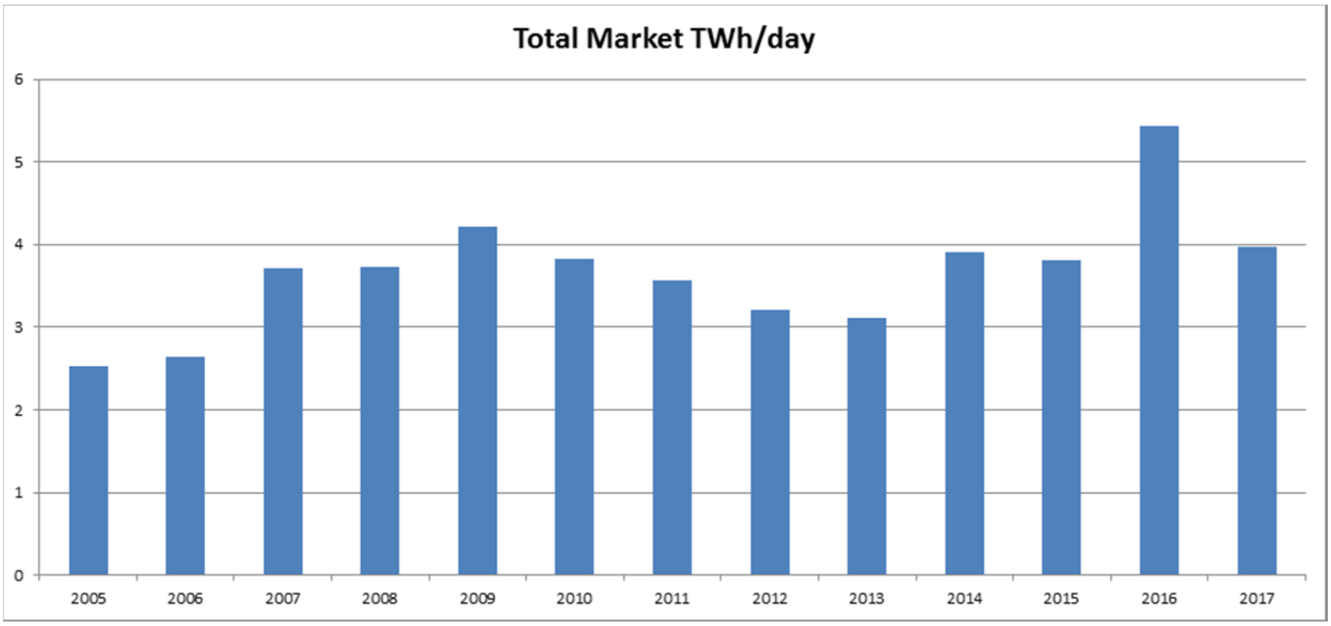

Figure 2: Total Trade Market Volumes

Total volumes and churn therefore provide little direct evidence as to the efficacy of the MMO when comparisons are drawn over longer periods or the impact of specific conditions are accounted for. Other metrics also fail to support a conclusion that the MMO has had a beneficial impact on overall market liquidity:

- **Significant churn between obligated parties.** A high and stable percentage (50-60%) of all trades and volumes is between the obligated market participants, suggesting that the obligation has not led to new sources of liquidity.
- **No significant entry of new players.** The identity and total number of traded counterparties has remained largely the same since 2014 and we have seen fewer counterparts in total during 2017 to date.
- **No entry of new financial players to replace the banks.** Unlike the period between 2001 and 2008 – when banks replaced exiting trading houses – few financial market participants have emerged to replace banks that have left the electricity market since 2009. This contrasts with the situation in the UK gas market where new financial market participants have emerged to replace the banks and liquidity has improved naturally.

Against this, as noted above, the most significant impact of the MMO has been the concentration of trade within the market making windows. This represents a new and significant barrier to the entry of financial market participants. Proprietary traders looking to trade spreads between power, fuel and carbon will typically want to change their power positions in response to news events and/or in response to changes in related markets throughout the day. Any trader seeking to execute a spread trade will also want to execute the power and gas legs concurrently rather than being forced to leave the power leg exposed until it can be closed during the next window. The concentration of liquidity within the windows therefore makes it significantly riskier and costlier to trade UK power because traders may need to wait for the liquid window to close their positions or to enter a new power position.

In summary, there is no evidence to suggest that the MMO has had a material impact on market liquidity overall, but significant cause for concern that the obligation may act to distort the pattern of trade, which in turn acts as a barrier to the entry of new players into the wholesale market.

Question 5: What are your views on the impact of the market making obligation on liquidity in different market conditions, including in benign times and in times of price volatility?

There is little evidence to suggest that the MMO has acted to improve underlying market liquidity. Market volumes, participants and the range of products have shown little change since the introduction of the obligation. Moreover, as noted above the concentration of the volumes into the windows has distorted the pattern of liquidity and raises barriers to the entry of new market participants.

The increase in market volumes in 2016 on the back of a significant increase in market volatility was to be expected; markets trade more when prices are high and volatile when compared to times when prices are low and flat.

The MMO naturally results in more traded volume and costs to the obligated parties at times of price volatility. Market spreads during volatile periods would otherwise widen to reflect the increased uncertainty and risks of entering into trades. When obligated spreads remain constrained below market levels, more trades are likely to result as prices cross artificially narrow spreads. Many of these trades will occur between the obligated parties as they seek to maintain spreads in difficult trading conditions and to exit trades that they would otherwise not have undertaken. It would be quite wrong to claim that this artificial increase in volumes indicates that the MMO improves liquidity at times of volatility. The opportunity cost of reversing these artificial increases in trade volumes is by far the most significant cost element to the obligated parties (see answer to question 10).

Question 6: What are your views on the fast market and volume cap rules, in particular on reducing risk for licensees when needed?

The fast market and volume cap rules have not been particularly useful in mitigating the risks to the obligated parties. Significant costs have already been incurred by the time that these provisions are triggered. On the specific provisions:

- Framing the fast market rule as a percentage means that obligated parties receive less relief at higher, volatile price levels. An absolute, rather than relative, price spread would be more appropriate.
- Significant price “gapping” often tends to occur around market opening. The effectiveness of the fast market rule is therefore significantly diminished by anchoring it to the first trade in the window (by which point any gap may have already occurred). While it is difficult to see how this issue could be resolved by amending the current fast market rule, our proposal to extend the windows – see answer to question 11 - to two hours would significantly mitigate the problem.

Question 7: What are your views on how the SMA part of the licence condition has helped smaller suppliers to access the wholesale market?

SMA would appear to have had some benefit in allowing smaller suppliers to execute trading agreements with a range of counterparties and providing greater access to the wholesale market. The evidence would suggest, however, that the benefits have been delivered more widely to smaller suppliers and largely outside the licence obligations surrounding a “request to trade”. However, the primary costs of meeting this obligation lie largely in maintaining the facility to respond to trade requests from eligible suppliers. This would suggest that the policy could be significantly streamlined by removing the obligations around a “request to trade” without a material impact on small suppliers.

Recent years have also seen significant growth in the provision of “direct market access” (DMA) services by several wholesale market participants. DMA providers allow smaller market participants to participate in the wholesale market directly. Smaller suppliers can effectively use the DMA providers’ credit lines and trading systems to execute trades and to post bids and offers directly in the market. This avoids the need for smaller participants to establish their own trading systems and a network of credit and trading agreements and significantly reduces the cost of entering the wholesale market. The emergence of a low-cost, competitive route to market for smaller suppliers further suggests that the obligations surrounding supplier market access can be significantly relaxed.

Question 8: What in your view are the additional relevant external policy factors we should consider in our assessment of Secure and Promote?

We agree with Ofgem that MIFID II is unlikely to have material impact.

RWE also welcomed the introduction of the reforms to the cash-out mechanism to better reflect market scarcity. We share Ofgem’s view that more economic and efficient cash-out prices provide market participants with the right incentives to hedge appropriately.

We share Ofgem's sentiment that there should not be any contradiction between a company discharging its obligations under MMO and compliance with REMIT. However, concerns about legitimate trading behaviour becoming subject to inappropriate enforcement action have significantly reduced traders' willingness to make markets outside of the obligation in recent years. We recognise that this is a difficult issue to address and that it is very hard for Ofgem to provide clear guidance or comfort on what is or isn't legitimate behaviour. Indeed the guidance that Ofgem has provided has arguably caused more concern, and less comfort, than intended. Ofgem should address this issue with further regular dialogue between the policy and enforcement teams and with market participants to increase mutual understanding of market practices and operations and to ensure that market abuse is properly targeted and that genuine liquidity provision is not deterred.

Question 9: What are your views on amending the licence condition to allow flexibility during certain market conditions?

RWE would not support flexibility to change the rules without due consideration and debate. This would introduce damaging uncertainty into the market, which could in itself further undermine liquidity. As a practical matter, even the time required to consider and consult on such changes under a more flexible regime is still unlikely to respond sufficiently promptly to changes in market conditions.

RWE would, however, support ex ante rules linking aspects of the obligation to observed market metrics, eg, by linking mandated spreads to price volatility.

Question 10: What are your views on the costs and benefits of complying with the policy either as an obligated licensee or as a general participant? Please provide evidence and detailed costs/ benefits per annum.

We estimate the costs of complying with the obligation to be between £3.5 million and £4 million. This breaks down into:

- direct resource costs of around £1.0 million for the trading, IT, risk, back-office and reporting costs associated with the MMO and the cost of maintaining the SMA facility;
- a cost of £2.5 to £3.0m to back out of trades that are undertaken under the obligation but would not have otherwise been executed. £2.5m equates to paying the bid-offer spread on just one clip of seasonal baseload per day which costs around £10,000 per day.

Question 11: How can liquidity be improved without the costs of the policy increasing significantly? Alternatively, how can costs of the policy be reduced without significantly reducing liquidity?

Ofgem should remove the MMO obligation from the obligated parties. While independent suppliers' access to the market has clearly improved - with large scale entry of new suppliers - there is little concrete evidence to suggest that MMO has improved liquidity when compared to the years before the obligation. There is, however, clear and unequivocal evidence that the MMO has distorted the pattern of trade, reduced the availability of genuine liquidity throughout the day and raised barriers to the entry of new wholesale market participants.

If Ofgem seeks to maintain mandated market making then it should be removed from the five obligated parties. The criteria for selecting those parties are unduly discriminatory when set in the context of a competitive retail and a generation market. The original criteria to select the parties based on vertical integration are arbitrary and questionable, particularly in the light of the CMA's finding that vertical integration does not have an impact on competition from independent generators and retailers. The obligation is also increasingly anachronistic and not robust to future changes in corporate structure given the decision of two of the original obligated parties to divest their retail businesses and “vertical integration” by other significant market participants.

The costs of the policy can also be reduced significantly while increasing liquidity by extending the market making windows to two hours each and by requiring the newly contracted/obligated parties to post bids and offers for 60 minutes within the extended windows. The newly extended windows would run from 09.30 to 11.30 and from 14.30 to 16.30. This has several key advantages over the current design of the obligation.

- **Extended price availability and liquidity.** Mandated spreads would be available for up to four hours per day. This would stimulate more genuine underlying liquidity in the market as market participants – including market makers - would enjoy a more flexible and effective choice on when and how to trade.
- **No risk to current liquidity.** Extended windows would not diminish the extent or size of the current obligation. Ofgem could ensure that the new market makers offered the same aggregate volume for at least two hours a day (eg, in the event that all market makers chose to fulfil the obligation in the first hour of the window).
- **Better aligned to market practice and reduced barriers to entry.** The extended morning and afternoon session would fit better with the “natural” pattern of trading in related products. They also help to remove the current distorted, narrow concentration of liquidity within the one hour windows. This would reduce barriers to the entry of new traders into the market.
- **Significantly reduced cost of compliance.** While each market maker would still be obliged to market make at mandated spreads for two hours daily, there is increased flexibility on when during the four window hours to meet the obligation. This additional flexibility allows the market to adjust more efficiently to fast market conditions and reduces the likelihood of unnecessary and costly churn between the obligated parties.

The costs of the policy could also be significantly reduced by aligning the product calendar more closely between the exchange and OTC markets. The calendar definitions for exchange and OTC product definitions differ slightly; seasons cascade into quarters, quarters into months etc on different dates. This means that traders may be obliged to market make for new contracts on these dates before existing positions have cascaded. This generates unnecessary and additional risk and cost in meeting the obligation because traders are effectively duplicating efforts around these cross-over dates. Ofgem could remedy this problem by linking the obligation explicitly to one specific calendar (eg, to the exchange calendar) or by defining in advance the relevant dates for obligated products to cascade.

Extending the range of obligated products would significantly increase the costs to obligated parties. The products covered by the obligation were and remain the most actively traded and liquid products. Expanding the list to less liquid products with longer time horizons or more granular blocks (eg, WD5 or WD6) would require obligated parties to make markets in products which are less liquid and actively traded. This would increase the cost of complying with the obligation significantly since parties would be paying much higher spreads to back out of unwanted positions in less liquid products.

Question 12: Is there any other relevant stakeholder feedback we haven't captured that we should consider?

The best indication of liquidity is the presence of independent proprietary traders in a market. Secure and Promote has not resulted in any significant entry from financial players to replace the banks leaving the market. This contrasts with the UK gas market where new financial players have emerged and liquidity has naturally improved. This suggests that the perceived lack of liquidity in the UK power market is driven by its underlying fundamentals and that policy should be focused on understanding and removing any unnecessary barriers to the entry rather than introducing new barriers in an attempt to "manufacture" liquidity. Ofgem should therefore actively seek views from independent proprietary commodity traders who are active in the UK gas market and other EU power markets. This would allow Ofgem to understand better traders' views on the UK power market and the underlying reasons for entering – or not entering – the wholesale market.