The voice of the energy industry

EMTC 37-17

Energy UK response to Ofgem's Secure and Promote Review consultation

22 September 2017

About Energy UK

Energy UK is the trade association for the GB energy industry with a membership of over 90 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership encompasses the truly diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 26 million homes and every business in Britain. Over 619,000 people in every corner of the country rely on the sector for their jobs with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry adds £83bn to the British economy, equivalent to 5% of GDP, and pays over £6bn in tax annually to HMT.

Executive Summary

Energy UK welcomes the opportunity to respond to Ofgem's consultation on reviewing the Secure and Promote license condition. Energy UK supports measures which improve liquidity, reduce costs and ensure the market is accessible to all participants. Effective competition in the wholesale market will improve the robustness of prices and lead to lower costs for consumers.

We consider that the main issues Ofgem should address as part of this review include:

- With the Secure and Promote license condition having been in place for over three years we consider that it is appropriate to review the policy and evaluate how it can be improved while reducing costs to market makers. Any changes to the policy should be underpinned by robust analysis by Ofgem to ensure the policy remains relevant.

- It is clear that all market participants benefit from greater liquidity, improved market access and robust reference prices. We consider that market making has a role to play in facilitating a healthy level of liquidity and product access. We encourage Ofgem not to make major changes at this point in time and to continue to monitor the development of reference prices and market re-entry by financial institutions.

- There are a number of improvements which we consider can be made to the Market Making Obligation (MMO) to improve liquidity for mandated products while reducing the cost to market makers. Ofgem should review options such as narrowing the Fast Market rule, exploring a 'soft landing' function and changes the parameters of the current obligation. These changes should be carried out without negatively impacting the current market and must be evidenced through a robust assessment on the impact of any changes on liquidity.

Energy UK welcomes the opportunity to further discuss the points raised within this consultation with Ofgem. Should you require further information or clarity on the issues outlined in this paper then please contact:

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Response to 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.

There is evidence to suggest the deeper liquidity pools within the market maker window are leading to more robust reference prices during normal market activity, important for trade throughout the day. Robust reference prices allow market participants to take a better view on the value of the market and enable the trading of financial products that can be settled against robust physical prices, however, it is to be expected that the bid offer spreads narrowed given that they are regulated.

We do, however, have concerns that liquidity is now concentrated in the two narrow mandated trading windows with liquidity outside of the windows significantly reduced. This poses several issues as the market no longer reacts to changes such as power station outages or changes to demand forecasts and market participants need to wait until the next window to trade power. Providing a robust reverence price while facilitating a well-functioning market is important to ensure the Secure and Promote license condition is fit for purpose.

There is also evidence that financial market participants are beginning to re-enter the market, which could lead to increased market churn. This activity should be encouraged and given time to develop.

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.

The mandated trading windows promote greater availability of products needed to hedge. As the Market Maker Obligation (MMO) mandates that obligated products are made available to the market it's no surprise that the availability has improved. We would add that before the Secure and Promote policy was implemented many of these products would have been traded in the market. Outside of the trading windows there is a significant reduction in liquidity and the availability of products needed for hedging.

The majority of GB generation businesses are principally focused on hedging their generation assets and will seek to trade in accordance with an appropriately risk adjusted hedging envelope. This approach minimises their risk exposure across the forward curve and ensures they remain competitive in the traded market. Whilst a continuously traded forward market is preferred, forward hedging activity has moved to the liquidity windows with relative ease – the deeper liquidity pools over shorter trading periods has not materially impacted forward hedging and may have improved access to longer dated products.

This poses a problem for physical asset owners where the transactions are for purposes other than position optimisation, i.e. due to short notice physical loss of load or forced outages.

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.

Overall, the Day-Ahead power market has a good level of liquidity in core products on the wholesale market. However, beyond Day-Ahead, liquidity falls away steeply as you move further ahead of delivery and away from Baseload to Peak and other products. Consequently, the near-term markets are not the area of greatest concern. The MMO is most effective and important through its application to Seasons +2, +3 and +4 and in particular in the Peak product. Without the MMO obligation across these seasons, we would anticipate a regression to the trading inactivity that typified the curve prior to the introduction of Secure and Promote.

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.

We consider that one area which would improve the analysis of the state of liquidity would be for Ofgem to review how much of the trades which are taking place between the obligated parties. For this analysis to be useful Ofgem would need to separate trades which are through the MMO and other trades which may be for a company's own needs or on behalf of a third party. Another area which would be useful to report on would be the net trading positions for the prompt market. We do not consider that gross values area good indicator of market liquidity and that paradox rejected block orders in the prompt market could give an indicator of true market liquidity.

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?

The MMO allows products to be available in the windows both in benign and volatile times with the costs incurred for proving liquidity changing depending on the amount of volatility in the market as the bid offer spreads expand. Where market conditions are unfavorable (during times of volatility the mandated spreads can be seen to be onerous on mandated parties) there are mechanisms, such as the Fast Market rule, which intend to limit the potential liability of the MMO parties. However, MMO parties agree that the parameters such as the Fast Market rule and regulated bid offer spreads are too rigid and can result in excessive costs at times of volatility for MMO's.

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 rule has been shown to be used when there is significant market volatility. The current trigger is set when the bid-offer-spreads vary by 4% which is considered to be too wide by all MMO parties. By the time the market has moved by that amount there may have been significant costs incurred by MMO parties. Energy UK recommends that the Fast Market rule be reviewed by Ofgem through thorough analysis that identifies the optimal level to reduce costs for obligated parties while not being triggered too often and impacting liquidity.

The current 30MW volume cap is also becoming a constraint as more suppliers become eligible suppliers and could result in some suppliers being unable to hedge their position. This is demonstrated by the increasing application of the volume cap. The volume cap chould therefore also be reviewed to ensure it remains set an appropriate level.

We note that the volume cap is currently an arbitrary number and should be based on the needs of the market more directly.

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

We consider that the SMA part of the licence has been successful in promoting access to mandated products in the market.

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 that the policy factors noted in this consultation are relevant in Ofgem's review of the Secure and Promote policy. Other factors which may impact future trading arrangements include the changes to electricity charging arrangements which will reduce the current level of revenue from the TNUoS embedded benefit meaning that this value will be recovered through the wholesale market instead. Increased occurrences of negative prices may also cause issues for the wholesale market in the future.

EBSCR and the move to PAR1 next November (2018) will increase the need for suppliers to balance their position to a greater degree of granularity to avoid extremely high system imbalance prices, especially in times of high volatility. In addition, to accrue the benefits of P272 and the forthcoming mandatory HH settlement SCR (as a result of the smart metering programme) suppliers will have a greater need to hedge their own bespoke shape rather than baseload and peak products.

We also note that Ofgem's position on scarcity pricing is positive and allows the market to price in scarcity when margins are tight. This will facilitate a well-functioning market and allow traders to put appropriate prices into the market.

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

Although we appreciate how flexibility during certain market conditions may be appealing we consider that the ability for Ofgem to react to short term market issues would take too long for any meaningful changes to occur. Ofgem should focus on ensuring the licence condition is appropriate when making any changes following this review.

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.

Energy UK is not an obligated licensee or a general participant in the market and therefore we cannot directly comment on the costs and benefits of the scheme. However, we consider that Ofgem should carry out a robust assessment of the costs/benefits submitted by different parties to ensure consistency and validity. The costs/benefits also need to be provided by Ofgem based on quantitative analysis where possible.

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?

We have been considering several options to improve the liquidity of the market. The options outlined below should be able to better facilitate the objectives of the Secure and Promote policy while limiting the costs for consumers.. The options outlined below should be able to better facilitate the objectives of the secure and promote policy while limiting the costs for consumers.

Changing the parameters of the current obligation

The MMO could evolve to reduce the financial impact on MMO parties and also improve market liquidity by addressing some of the key concerns stakeholders have raised to date. Proposals include, for example, changing the available of products which could be reduced from 100% for the obligation window but in return the size of the windows could be doubled. This would allow the market to function more normally with products available the same amount during the windows this would also allow MMO companies to mitigate some of the risk faced when the market moves.
The exact parameters would need to be reviewed by Ofgem to find an optimum obligation level for the duration and product availability. If Ofgem did make changes to the current obligation it would need to ensure that MMO parties were still creating a liquid market with clear parameters on how the revised obligation would improve liquidity. For example, if the obligated parties were posting numbers on and off the screen regularly this might impact liquidity negatively and impact the smooth working of the market.

Introduction of a 'soft-landing'

This would allow obligated licensees to submit wider bid-offer spreads in the first 5 minutes of each trading window, when price discovery takes place. At times of extreme market volatility, as observed in Q4 2016, there can be significant uncertainty at the start of a trading window regarding the value of some contracts (e.g. M+1 peakload) when there have been significant price movements since the previous trading window. In such circumstances the submission of bids can be at levels above offers as orders are initially submitted, causing confusion and unnecessary consumer costs. However there needs to be clear parameters that will ensure no reduction in liquidity.

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

No comment.