Secure and Promote review: Consultation

-

OVO's response

18/09/17

1. Introduction

This is Ovo Energy's response to the consultation questions that were sent out to UK electricity market participants.

Ovo Energy believe that Secure and Promote has been a very positive initiative in driving a UK electricity market that provides increased wholesale market liquidity, increase retail market competition and fairer pricing for the end consumer. A dampening or relaxation of any of the rules surrounding Secure and Promote would risk making it harder for smaller independent suppliers to access fair market prices and therefore could have a negative impact on competition.

Ovo Energy firmly believes that the market making windows are an essential rule to ensure smaller suppliers can procure wholesale energy at a market reflective prices and limits the competitive advantage that the "Big 6" hold over other retail market participants. If the bid offer spread was increased during the market making windows then we believe this increased spread would directly impact the cost of wholesale energy for smaller suppliers, and this would impact end consumer as suppliers would need to pass through their increased wholesale commodity costs.

We would support an extension of the market making obligation to capture some of the non-standard products that are required to enable independent suppliers to effectively hedge their customer load shape (i.e. Winter EFA Block 5). We are open to changes to the selection of Market Makers if this will reduce the overall cost to the industry but believe that it is right that any costs are borne by the larger vertically integrated suppliers who benefit from the competitive advantage of lower transaction costs.

2. Ovo's Answers To the Survey 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.

Currently we believe forward prices to be robust within the liquidity windows for the Base and Peak products but outside of these windows there are a very limited number of bids/offers. In addition, there is very little liquidity in the non-standard products (i.e. 4 hour blocks, overnights etc.). For independent suppliers, the relevant price for forward delivery is for a retail customer load shape. Establishing the fair value of this shape is extremely difficult when there is very little liquidity in any non-standard products.

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 windows do provide increased availability to hedge but it is questionable if there are enough products to enable small suppliers to hedge retail shape well enough. Overnights and Winter EFA 5 are important hedging products that have very limited liquidity.

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 DA liquidity is good but beyond that, liquidity is very poor. The front 2 or 3 weeks seem to have the worst liquidity anywhere on the curve. Front week and front month liquidity is poor especially with regards to any products other than Base and Peaks. It is very difficult to shape more than Base or Peaks until the day ahead stage. With an ever-increasing percentage of generation coming from intermittent renewable sources there appears to be less generation traded in the near part of the curve as renewables seem to trade at the DA stage.

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.

The reported volumes in the DA auctions is very misleading to the market. It would be very easy to report net traded volumes in the auction rather than gross, and this would give market participants a better idea as to what volume is transacting in the auction. Reporting non-price sensitive volumes that no counterparty ever had a chance to transact with does not increase confidence in the auction as a reference price and probably has the reverse effect. A better analysis of liquidity for the auctions may include looking into the numbers of paradoxically rejected orders.

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 are very rare occasions where it looks like a market maker either buys or sells a product they didn't want to and then buys or sells it back from another market maker at a slight loss. This can lead to further price volatility. This is rare but was seen in the more volatile periods at the end of 2016.

In benign market conditions it can be a common occurrence that the power has an implied offered or bid via the spark spread market which is better than the straight power Baseload product.

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

I do believe these could be introduced to stop the licensees incurring material losses if speculators want to take advantage of the market making obligations in times of high volatility. It could be an option to introduce varied spread limits depending on observed volatility over a given period.

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

No view.

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

The changes to Cash Out rules coupled with the increase in intermittent renewable generation have led to increased risk of extreme prices during peak demand periods. This has increased the requirement of independent suppliers to hedge these peak demand periods ahead of the short term market. The lack of liquidity in block products, and in Winter EFA Block 5 in particular, is therefore becoming an increasing concern,

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

It could be an option to introduce varied spread limits depending on observed volatility over a given period. We would be strongly against any suggestion that market making obligations would be suspended under certain market conditions.

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.

Looking at the following statement in the report;

"3.8. Early feedback on the policy suggested that the ongoing costs were significantly below those predicted in our impact assessment. However, more recently some licensees have raised concerns about escalating costs during periods of price volatility."

We would suggest that the increased cost during volatile periods was priced into initial assessment of overall cost which was deemed to be an acceptable level. We would therefore argue that there is no real financial argument to change anything due to increased costs in an isolated period.

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?

If more blocks (i.e. Winter EFA Block 5, Overnights) were introduced into the mandatory products you could reduce the volume cap on each product to ensure overall exposure to price movements remains the same.

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

We wish to reiterate that any increase in the bid offer spread will increase costs to smaller suppliers as they generally have to buy at offer as don't have direct market access. A bid offer spread that is any wider will mean that small suppliers will be paying higher prices for their wholesale energy compared to large companies that have direct market access.

A change to relax the MMO rules would be a material change for all the small suppliers that have recently come into the market. We do not think it makes sense to have a large increase in supplier numbers and then remove some of the rules that facilitated this increased competition.