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Dear Matthew/Hannah

Secure and Promote Review: Consultation

SSE welcomes the opportunity to respond to Ofgem's consultation on its review of the Secure and Promote (S&P) licence condition.

When consulting on the introduction of S&P Ofgem committed to undertake an in-depth review of liquidity after a certain period (for example, 3-5 years) and that this review would allow a broader consideration of the market, looking at the overall state of liquidity, evaluate whether intervention is still required, and consider whether S&P remains the best option for intervention. We understand that this consultation is Ofgem's initial step towards carrying out this in-depth review.

SSE was supportive of the Market Making proposal when it was first introduced by Ofgem in 2014. Effective market making should instil greater confidence in the forward markets and encourage other participants to actively trade in the market. Whilst we continue to strongly support the promotion of an effective forward electricity market and increased liquidity, we are concerned that the Market Making Obligation (MMO) has not had any notable effect on liquidity.

Based on Ofgem's annual liquidity reports and wholesale market indicators published over the last three years, there is no evidence that churn or overall volumes traded in the market have increased significantly. There is also no evidence of increased participation by non-obligated parties. As such, we do not believe that S&P has given liquidity the 'kick start' that it was intended to deliver.

We do not agree that simply continuing with S&P for a period of time to enable further assessment is a suitable option. Ofgem and the market have had 3+ years of experience with the licence condition and should be able to assess its impacts. This may involve a requirement for Ofgem to gather more qualitative and quantitative evidence from a targeted group of non-obligated parties to understand their experiences participating in the market since the introduction of S&P.

We understand from the consultation that Ofgem is currently considering whether any elements of the policy should be relaxed or refined to better facilitate the policy objectives and/or address risks faced by the obligated parties. As outlined above, our view is that further in-depth work by Ofgem is required to assess the impacts of the S&P policy against its original objectives. We do consider, however, that there are specific design elements of the MMO which should be changed at this stage to address some of the penalising effects that it has on the obligated parties. These changes are detailed in our response to Question 11 further in this document.

It is important that any changes to the MMO identified through the initial consultation process are further consulted on prior to being introduced in the generation licence.

We welcome the opportunity to engage further with Ofgem as it progresses with its review.

Please see our response to the consultation questions further in this document.

Yours sincerely,

Lois Wares
Regulation

Appendix: 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.*

Ofgem's definition of price robustness on page 9 of the consultation document refers to 'underlying value of the product' and 'narrower bid-offer' spreads. While the MMO has introduced mandatory bid-offer spreads, it is difficult to measure how effective price discovery has been on the forward curve beyond simply assessing the trading volume of different longer term products. An important indicator for Ofgem also to consider in assessing 'robustness' of forward prices is the number and type of 'other' players (i.e. non-obligated parties) who are actively participating in the forward market. As more market participants trade a particular product, information is revealed about its valuation and this can be incorporated in the market price. In our view further in-depth analysis of the impact of S&P on market price formation is required in addition to the information already presented in Ofgem's annual liquidity reports. For example, we would argue that in the absence of any noticeable increased participation by players other than the market makers, a level of price 'robustness' beyond what was available before S&P has not improved.

It is our view that there is also an important role to be played by price reporting agencies to produce an index based on an independent assessment of the prices in the market. This will help establish a formal reference price and will provide market participants with an independently assessed pricing benchmark. Please see our response to Question 4 with our detailed views on Ofgem's analysis of the state of liquidity, including our comments on the mandated bid-offer spreads.

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 would strongly argue that the products needed to hedge were already widely available in the market before the introduction of the MMO. This was demonstrated by the Competition and Markets Authority (CMA) in the final report of its Energy Market Investigation, as published June 2016, which states:

"…our analysis of wholesale market liquidity suggests that vertically integrated firms carry out extensive external trading, and liquidity in the products that vertically integrated firms use to hedge their exposure to wholesale market risk is sufficient for independent firms to hedge in a similar way."

Based on the data available in Ofgem's annual liquidity reports and wholesale market indicators published over the last three years, we see no evidence that the MMO windows have promoted greater availability of these mandated electricity products.

Please see our response to Question 4 for views on Ofgem's analysis of the state of liquidity, including our comments on traded volumes and churn.

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

We are aligned with Ofgem's view that the near-term market continues to be sufficiently liquid.

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.

<u>Traded volumes</u>
Based on the data collated in Ofgem's annual liquidity reports we see no significant increase in the overall traded volumes since the S&P licence condition has been introduced. We note from Ofgem's reports that it has observed an increase in the volume of trading in specific mandated products. Market liquidity is, however, variable and with a large degree of selection on products by market participants as well as changing supply and demand requirements and market trends, it should be measured on a whole market basis.

We have observed that trading is concentrated within the two market making windows. Notably, this concentration increases further during periods of market volatility. It could be suggested that obligated parties are being penalised by the obligation to post bids and offers at times where they face the greatest risk.

<u>Churn</u>
Based on the monthly churn data published by Ofgem, total churn continues to range largely between 2 and 5, averaging at 3.8 since the introduction of S&P. Seasonal variations remain. In certain months churn has ranged up to 6, which is reflective of market volatility and managing the risk that comes with an obligation to post bids and offers on certain products at these times. Between 2010 and the introduction of S&P in Q2 2014, total monthly churn was averaging at 4, indicating that there has been no particular change.

We note that Ofgem continues to compare churn for electricity products with that for gas, however it is important to highlight that there are fundamental differences between electricity and gas which should be taken into consideration by Ofgem when undertaking this type of comparison. These factors are outlined in more detail in the CMA Energy Market

Investigation report. Notably, the CMA states in its final report that "…it would be unreasonable to set liquidity in gas as the benchmark against which to judge liquidity in electricity."

Bid-offer spreads

With regard to the bid-offer spreads, we note from the data available in Ofgem's annual liquidity reports that beyond the initial drop when the mandated spreads were first introduced there have been no significant reductions in the spreads since S&P. It has been our experience in the market that in periods of normal volatility, the spread is generally tighter and below the mandated spreads. We believe that evidence of spreads remaining tight out with the windows but little trading occurring demonstrates that availability for these products is there but there is little demand.

Other indicators

One additional important metric for monitoring the effectiveness of the forward electricity market is the number of trading counterparties. As explained in our response to Question 1, as more market participants trade a particular product, information is revealed about its valuation and this can be incorporated in the market price. We consider it is important that Ofgem starts gathering information and reporting on the number of market players/new entrants per year, number of active traders, volume by trader type: retailer, financial, market maker. A high number and diverse range of market participants trading in forward markets is an important factor contributing to the formation of robust forward prices.

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?

We have outlined our views of the high-level state of liquidity in response to the previous questions.

In our view increased trading activity during periods of market volatility is naturally to be expected. An additional obligation to post bids and offers further contributes to increased trading activity during volatile market periods. For the reasons outlined in our responses to the previous questions, we do not believe that any such increase in trading by the market makers is reflective of increased market liquidity.

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

In principle, we are supportive of the protection that the fast market and volume cap rules were intended to provide but that in practise they continue to leave obligated parties open to unnecessary risk.

Volume cap
Our experience has been that we can trade well over 30MW's for a front month in any one window. For example, we can trade baseload and peaks for October (M+1), Q4 (Q+1) and Winter 17 (Season+1) during the window and as such these periods overlap. We could be lifted on all 6 products leaving us exposed to 180MW peak short on our front month position. We feel that the net 30MW cap on overlapping periods is excessive and brings particular risk in periods of volatility. As a market maker we can also trade through the window aggressing into numbers yet these don't show in our obligation despite adding to the market liquidity. We believe that any trades should count to a 'gross' level of 30MW in overlapping periods and that this should relate to both initiated or aggressed trades.

Fast market
We do not believe the fast market trigger is particularly effective due to the fact that it is measured from the first trade in each MMO window and not from the first trade of the day. The fast market trigger was intended to protect obligated parties from the price changes that come as a result of extreme volatility in the market as a whole, however in its current application it does not recognise trading and price changes leading up to the window. Our experience has been that we can be trading in the market up to the window, with conditions being close to reaching a fast market only for this measurement to have to 're-start' again from the beginning of the window, leaving us open to price risk. We believe that in order to provide the protection that was intended in these particular market conditions, the fast market should be measured from the first trade of the day.

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 believe that SMA has been useful for setting a benchmark for the standards of service small suppliers should expect to receive when negotiating trading agreements. Given that these are service standards rather than an obligation to trade, we would suggest that all market participants, not just those currently obligated, are capable of meeting this benchmark.

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

Competition in the supply market
The S&P licence condition was introduced to address Ofgem's concerns that wholesale electricity market liquidity was poor and was posing a barrier to effective competition and entry in the generation and supply market. Since 2012, the number of active suppliers in the domestic gas and electricity retail markets has increased due to a significant entry of new suppliers. This growth accelerated throughout 2015 and 2016 with a net entry of 27 new

suppliers. Until 2012, suppliers other than the ‘Big Six’ held a market share of below 2%. Since then, their share has grown significantly, reaching 17% in Q1 2017. Small suppliers have reached a combined market share of 6% in Q1 2017. The combined market share of small and medium suppliers now outweighs that of some of the supply businesses of the ‘Big Six’.

CMA findings

Since the introduction of S&P the CMA has completed its Energy Market Investigation, with the final report presenting a number of conclusions regarding the state of liquidity in the forward electricity market and the effects this is likely to have on competition. Using the same indicators as applied by Ofgem (churn, volume of trading, availability and spreads) and through seeking some additional feedback from market participants, the CMA concluded that S&P had not appeared to have had broader effects on liquidity and, as such, it was not obvious that “micro-level interventions” had any potential to cause a step change in the overall level of liquidity. The CMA also concluded that whilst S&P (in particular the MMO) was likely to be of benefit to smaller suppliers and generators by giving them certainty over the availability of mandated products every day and further transparency over market prices for those products, S&P in itself was not necessary for competition.

As referred to in our response to Question 4 there are a number of factors with the potential to affect market liquidity for electricity. These range from the practicalities of storing electricity and the sheer number and range of electricity products available, to regulatory and policy uncertainties which make it unattractive to trade in electricity products beyond a certain time horizon. We believe these and the additional factors identified by the CMA in its final report are important and should be further explored by Ofgem in its future liquidity reports.

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

We have outlined our concerns with certain design elements of the MMO in response to Question 11. If the risks we have outlined can be addressed then we do not think there should be any requirement to introduce flexibility to the licence condition during volatile market conditions.

In the absence of these changes we do think Ofgem should have the power to remove or relax the requirements on the obligated parties when particularly volatile market conditions arise, however Ofgem would have to be able to recognise and react quickly to changing market conditions to effectively enable this flexibility to the obligated parties. It is not clear how this could be implemented in practise.

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 have outlined our views on the benefits we believe that S&P has brought to the market and the risks that are placed on obligated parties in the previous questions. It is difficult to assess the actual costs and benefits (financial) to obligated parties of delivering S&P. We believe that Ofgem should continue to focus its in-depth review on assessing liquidity in the market and understanding the impacts of S&P, as per its original intent.

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 do not believe there are any quick fixes to the existing policy which will have the effect of improving liquidity. Liquidity should improve as the number of participants trading in the market increases. If to date, the existing policy has not had this effect then a more fundamental change to the policy should be considered. Ofgem should consider gathering more qualitative information from those parties not currently trading or trading a limited volume in the forward market, to better understand what would drive an increase in participation.

We would also be interested in engaging directly with Ofgem as part of this process to discuss our views on particular interventions that we consider would be more effective in delivering the original policy intent. For example, we believe that alternative solutions such as an auction or indexation model would be more effective and should be explored further.

We do, however, consider that in the meantime there are some minimal design changes that could be made to the MMO which will alleviate some of the punitive elements currently affecting obligated parties. We do not consider that these incremental changes, once introduced, will have an impact on liquidity.

1. Our experience through managing our obligation is that the existing bid-offer spreads, supported by a relatively large volume cap, have the effect of exposing obligated parties to large open positions which are difficult to manage. We note that the spreads are tighter for the nearer term more volatile products, compared with the wider spreads for Season+3 ahead. This results in all efforts during the windows being spent on managing positions in these more volatile products, leaving little opportunity to trade the further dated products. A simple solution to this would be a widening of the spreads, particularly for these nearer term products, although we see no need to have differing spreads across the curve. We would suggest that an increase to 1% for both the baseload and peak spreads would help

protect against event based volatility (spikes in gas, oil, coal). Our experience in the market has been that in periods of normal volatility, the spread is generally tighter and as such altering the spreads in this way shouldn't impact on liquidity, it will simply offer a protection to the obligated parties through periods of high volatility and limited market liquidity. We note that the current spreads were not based on any specific market metrics therefore a reasonable suggestion would be to trial this change over a number of months to measure its impact.

2. Secondly, the timing of the afternoon window coinciding with the publication of U.S. oil stock data means that GB gas prices feeding into electricity prices are more volatile compared to other times in the afternoon. In addition, with the MMO window ending at 16:30 this leaves little opportunity after the window to do further trading to manage any positions opened as a result of the MMO. To address these issues we believe it would be beneficial to move the afternoon window forward by one hour (14:30). This would partially address the existing volatility risk faced by the obligated parties and should also promote more trading at the end of the day, as opposed to the drop off in activity after 16:30 as observed currently.

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

When S&P was first introduced Ofgem set out its criteria for determining who should face the MMO. We continue to believe that these criteria should be reassessed and that other market participants are equally as capable of delivering the MMO.

<u>The domestic supply market and vertical integration</u>: In Ofgem's 2013 final proposals for S&P it was suggested that large domestic suppliers and vertically integrated companies with both a generation and supply market presence are not incentivised to trade frequently in the market and that an intervention was needed to ensure that these large companies fully engage in the wholesale market. These assumptions are not aligned with the CMA's findings which assessed that these companies were trading multiples of the size of their final consumption and generation, making a net contribution to liquidity.

<u>Trading capabilities and effectiveness of the intervention</u>: There are a number of other market participants beyond the six (now five) largest vertically integrated companies, who trade extensively in the wholesale market and are equally as capable of delivering the MMO at the same cost and further supporting the availability of products, price discovery and enhancement of liquidity.