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Secure and Promote Review: Consultation

Dear Matthew/Hannah.

SmartestEnergy welcomes the opportunity to respond to Ofgem's consultation on the Secure and Promote Review.

SmartestEnergy is an aggregator of embedded generation in the wholesale market, an aggregator of demand and frequency services and a supplier in the electricity retail market, serving large corporate and group organisations.

Please note that our response is not confidential.

We answer the questions below in the order in which they appear in the consultation document.

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.

> We are not convinced that churn has gone up year on year as a result of the S&P initiatives. Volume has merely increased as a function of volatility. We have observed a trend of more trading in the windows and a corresponding lack of liquidity outside of the windows.
>
> Spreads had already reduced in the years leading up to April 2014 and have not changed significantly over the period since the implementation of the policy.
>
> The document states the following: "There has been an upwards trend in bid-offer spreads over the period in the non-mandated products (dashed lines). This indicates that in the absence of Secure and Promote that narrower spreads would likely have remained unavailable both inside and outside the windows." We do not agree that

this is a logical conclusion; the spreads are a function of the liquidity which has diverged since the introduction S&P.

If the fundamentals, such as fuel prices, move outside of the windows then it is much harder than it was previously to hedge any power exposure. This is a particular concern to a supplier without assets, such as SmartestEnergy. Any liquidity gains perceived by Ofgem are certainly only within the windows, and are at the expense of robust prices throughout the day.

Equally, mandating such tight spreads from participants who may not have that natural position leads to them automating their levels to manage their risk. This is understandable and reasonable on their part. The consequence for those trying to hedge an exposure is a frequently moving target and more noise around the current market view of the curve. This actively makes the traded prices less robust.

Although we're sceptical of the value of the MMM approach, if the obligation is to remain it could be tweaked to better meet its objective; by covering the whole day at a wider spread liquidity would be more likely to be present when the fundamentals move. Equally, it would still provide a good indication of the value, but leave genuine buying and selling interests as the best prices in the bid and offer stack.

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 have heard tell that traders of obligated parties are so focused on the obligations that there is less trading outside of the windows and less focus on longer term products. The obligated parties are apparently expending effort on avoiding enforcement.

The products the obligation has focussed on are the ones that were already acceptably liquid, at least until the point that a liquidity review was in progress for a number of years.

Products that are not mandated are perhaps slightly easier to establish a market in outside of the window. For example, a weekday block 5 market is likely to be considered by anyone valuing it in relation to the peak price. If the peak price is rapidly moving around due to previously described (and justifiable) automation then it makes it harder to reach fair value between the parties.

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.

There is sufficient liquidity in the within day and day ahead markets, although the auction has undermined the day ahead GTMA market to some extent.

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 assessing liquidity or Secure and Promote? Please provide quantitative or qualitative evidence where relevant.

> The availability of more granular products along the curve would reduce the extreme volatility associated with rare events.

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?

> It goes without saying that the market making obligation has improved liquidity within the windows but it has also reduced it outside. Overall the net effect is about the same. We would prefer longer windows.

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

> We understand that the Big 6 generally feel that the arrangements have been too rigid to deal with the volatility of Q4 2016. The relatively high use of the volume cap compared with the fast market rule suggests to us that the Big 6 have been slow to react to moving conditions and a wider spread in such conditions would be preferable as it would allow trading to continue for longer.

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

> It is our perception that the SMA aspect of the rules has helped a very small number of participants trading very small volumes. The market as a whole has not really benefited much from this.

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

> Consideration of MiFID II and REMIT is not relevant. The additional volatility brought about as a result of P305 should be borne in mind in consideration of the need to facilitate greater trading through wider spreads.

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

We can understand that the obligated companies would be nervous about such an unspecified risk to their businesses and we understand and would support this view if there were a quid pro quo in the form of more products under the scope such as extended peaks and more granularity along the curve i.e. make some of the granular products that are available seasonally monthly. It stands to reason that there should be variable spreads to reflect volatility and wider windows.

We believe that the changes needed could be made in a one-off licence change and the flexibility Ofgem speak of is not needed.

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.

The cost of compliance has informally been claimed to be £3-4m per obligated party. This includes staff, IT and reversing position costs. Given that these costs are probably slightly exaggerated they are not completely out of kilter with Ofgem's original estimates.

We are not convinced that the costs purportedly incurred by certain parties in complying with the policy would increase significantly if the range of products were increased and the spreads relaxed slightly.

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?

See answers to Q10.

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

No

Should you require further clarification on this matter, please do not hesitate to contact me.

Yours sincerely,

Colin Prestwich
Head of Regulatory Affairs

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