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19th September 2017

RE: Secure and Promote Review

Dear Sir / Madam,

Thank you for the opportunity to respond to your consultation on the review of the Secure and Promote policy. This response represents the view of the Centrica group of companies, excluding Centrica Storage. The main part of the response is non-confidential and can be published on Ofgem's website. We also attach a separate confidential annex containing information on the costs we have incurred to date from performing the MMO function.

Since the introduction of the Secure and Promote policy 2014, the market has changed to such an extent that the MMO part of the policy is no longer required or justifiable. Furthermore, the policy is distorting the market. Over the last 12 months, Centrica has informed Ofgem through letters, bilateral conversations and various pieces of analysis of the inadequacies of the Secure and Promote policy and of the urgency required to make changes before the coming winter. We are therefore disappointed by the belated timing of this review and that it does not envisage the wholesale review of the policy that was promised when the policy was introduced in 2014.

Ofgem should launch an in-depth strategic review, as was envisaged in 2014, which considers whether the MMO policy is still needed and, if so, what form it should take. In addition, given the significant distortions being introduced into the market, it is essential that Ofgem either suspends the MMO, in whole or in part; and / or undertakes an emergency adjustment of scheme parameters. The emergence suspension / adjustment of the parameters needs to be undertaken before this winter when the potential for volatile prices is highest.

The MMO should be subject to a strategic review examining whether the policy is still needed

The MMO was introduced in response to a market structure in which vertical integration was the norm and liquidity was assessed as being unsatisfactory by Ofgem. Since then the market has changed to the extent that it is almost unrecognisable from the market that the policy was designed for and we therefore believe that a full review needs to be undertaken to assess whether the policy is still necessary. It is Centrica's view that the changes to the market structure have fatally undermined any rationale for maintaining the policy.

First, liquidity has increased substantially under a number of metrics. Ofgem's own data shows that the volume of longer dated contracts (Season +2, 3 and 4) has increased from 262 TWh in 2013 to 441 TWh in 2016, whilst OTC peak forward contracts (between 2 and 24 months) increased from 21.9 TWh in 2013 to 67.0 TWh in 2016, representing a threefold increase. This would suggest that Ofgem's concerns from 2014 of limited liquidity have been addressed.

The structure of the generation market has also changed significantly. Many new independent generators have entered the market, providing suppliers with a much wider market place from which to purchase their power. Distributed generation is a reality and suppliers' access to the market has also improved through market access/route to market services that are available on commercial terms. Vertical integration is no longer the defining feature of the market, largely because it no longer the optimum way of structuring an energy company. Furthermore, even where it does exist, it has been categorically proven that it does not negatively affect liquidity. Indeed, the CMA's final report on the Energy Market Investigation concluded that "*vertical integration does not appear to have a significant impact on liquidity"*[1].

Furthermore, any perceived barriers to entry into the supply market appear to have disappeared since the introduction of the policy. The number of electricity suppliers has increased from 20 before to 46 for either electricity or dual fuel. This equates to 2.5 times more suppliers that are currently in the market than were in the market in December 2013[2].

The MMO has introduced additional unforeseen costs and distorted the market

In addition to the MMO no longer being justified, the costs of complying with the MMO are excessive, especially at times of high volatility. Indeed, the costs incurred in 2016 from market making were much higher than the 'high-case' forecasts in Ofgem's impact assessment which we believe is unacceptable, particularly without any form of compensation for undertaking the activity. We have attached a confidential annex detailing the costs we have incurred from performing the MMO since its introduction.

A further issue is that these costs are unpredictable and uncontrollable as they vary significantly depending on market conditions. The high costs incurred are largely due to the rigidity of the MMO parameters which do not provide sufficient protection in volatile market conditions. We provide further analysis on this in our answers to the individual questions. The rigid MMO parameters have essentially provided 'false' liquidity and the same liquidity or more could be provided at lower cost by adjusting the current parameters or by developing an alternative. We believe that the costs of maintaining the policy are larger than the benefits which in any case are difficult to attribute to the MMO in isolation.

Finally, we note that when developing the policy, Ofgem described the MMO as 'an external shock' introduced 'to set liquidity on an upward path', implying that the policy should not be considered as an enduring solution. In line with this thinking, Ofgem also stated that this review currently being undertaken would "look at the overall state of liquidity in the market, evaluate whether intervention is still required, and consider whether S&P remains the best option for intervention."[3] We are therefore disappointed that this consultation does not envisage the wholesale review of the policy that was promised.

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[1] See point 7.129 to 7.137 of the CMA Energy market investigation – Final report 24 June 2016

[2] Ofgem: number of active domestic suppliers by fuel type (GB) https://www.ofgem.gov.uk/data-portal/retail-market-indicators

[3] Wholesale power market liquidity: statutory consultation on the 'Secure and Promote' licence condition - Impact Assessment, p41

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Ahead of a strategic review, an emergency solution is required for this winter when the risk of volatile prices is highest

Given the proximity to winter, immediate action is needed to address the market distortions created by the strict parameters of the MMO. There should be an interim suspension of the MMO, in whole or in part; and / or an emergency adjustment of scheme parameters. At the very least, we recommend that for the period November – March, Ofgem reduces the Fast Market Rule (FMR) from 4% to 1%. This would be a more proportionate trigger to protect MMO parties from negative impacts during stressed market conditions and our analysis shows that liquidity would only be marginally affected by such a move (see answer to question 6).

In addition, we ask that Ofgem widen the bid-offer spreads by four times for all MMO products for the same period. We acknowledge that this solution would not solve permanently the inherent rigidity of pre-set bid-offer spreads but should be sufficient on an emergency basis to limit most of the negative impacts of the policy this winter.

Below we provide detailed answers to the individual questions. We hope this response is helpful. If there are any of the points raised in this response that you would like to discuss in more detail feel free to contact me on 07789 579169.

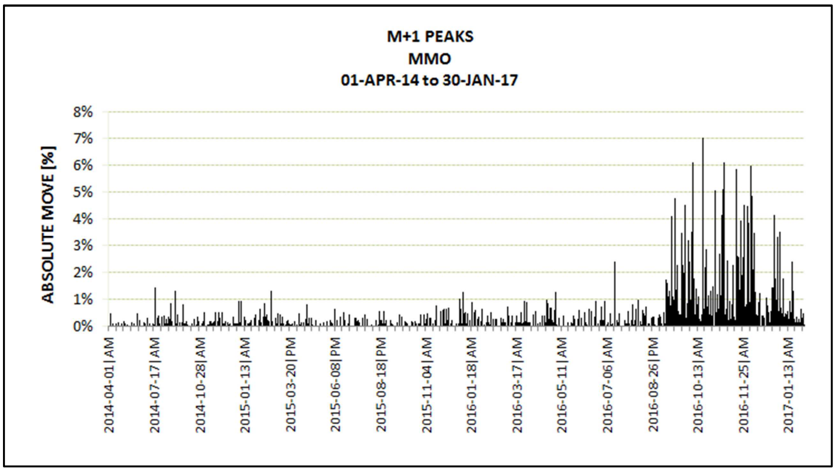
Yours sincerely,
Ricky Hill
Regulatory Manager

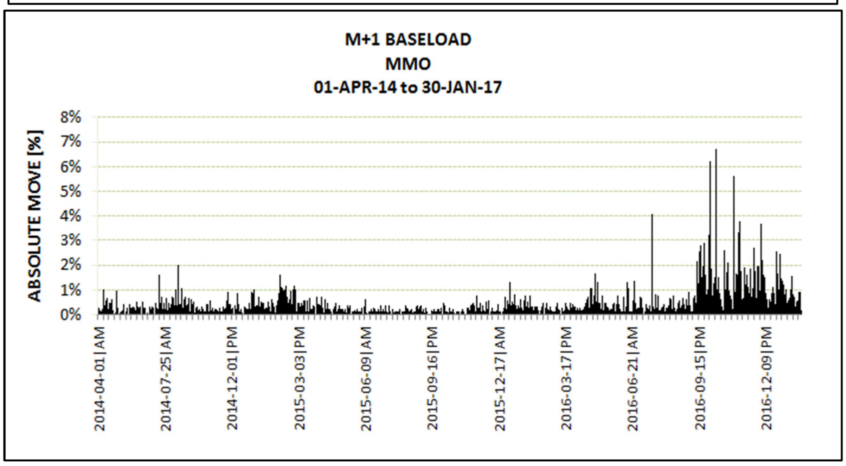
Question 1: Please comment on whether you think prices for forward delivery are robust. Please refer to prices in and out of the market making windows and comment on the current mandated bid-offer spreads.

The Market Making Obligation has not resulted in robust prices for forward delivery. Ofgem implies that the narrower bid offer spreads means that prices are more robust as they properly ‘reflect the underlying value of the contract’. A more useful definition of ‘robust’ would be one which considers whether the resultant prices provide a solid reference price which is readily available for market participants to hedge their positions throughout the trading day.

The current MMO has not provided for this on two accounts. First, the MMO has drawn virtually all liquidity into the two hour-long MMO windows with very little outside. Although Ofgem rightly acknowledges that liquidity is being concentrated in the MMO windows (Figure 14 in consultation document), it does not consider the impact that this is having on market participants. The second reason why the MMO cannot be considered to have resulted in robust prices is that the fixed bid / offer spread exacerbates price volatility.

The MMO rules result in significant swings in prices, especially at times of market tightness. Below we have analysed the price movements for Month + 1 products in each MMO window since the introduction of the policy, and as can be seen, price swings of up to 7% were experienced in the winter of 2016. We have reason to believe that the MMO feed markets volatility as obligated parties seek to cover their unwanted transactions and restore a ‘flat’ position as soon as possible. Such volatility is highly damaging to the market as it creates a high degree of uncertainty amongst traders as to the market price, and also risks providing market participants with an opportunity to push the price in specific directions in the knowledge that obligated parties will be looking to cover their unwanted positions.





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Source: Centrica

Furthermore, the MMO leads to a very low level of engagement by non-MMO obligated parties when it comes to initiate trading activity. This is because there is an expectation that MMO parties will have to post prices at favourable levels during the windows so there is little incentive for others to initiate trading. The leads to a situation whereby virtually all market making is undertaken by obligated parties and very little is undertaken by other parties.

Finally, we do not believe it is informative to compare electricity bid-offer spreads with those in the gas market as Ofgem does on page 9. In particular, we do not think there is any justification for Ofgem basing the mandated MMO bid-offer spreads on those seen in the gas market. The structure of the wholesale gas market is entirely different (e.g. churn is much higher in the gas market than in the power market at 20 versus 5, traded volumes are nearly 10 times higher in gas than power) which means the resultant bid-offer spreads are likely to be divergent.

Fundamentally, a properly functioning wholesale market would need to see bid-offers rise when conditions are more volatile and decline when market conditions are benign. The bid-offers fell below the MMO cap when volatility was low during 2015 but the MMO cap then prevented the market from functioning normally and effectively when it became much more volatile in H2 2016.

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.

Overall, there is little evidence that the MMO has resulted in the greater availability of products needed to hedge. The MMO mandated products were readily available and traded before the introduction of the policy. As we noted in our response to question 2, a key negative development that the policy has brought about is the concentration of virtually all liquidity within the MMO windows reducing parties' ability to hedge outside of the window. In other words, whereas the MMO products were previously traded throughout the day before the introduction of the policy, they are now only readily available in the MMO windows.

It should also be noted that forward wholesale markets are not designed to make all products available to cover a supplier's demand shape and therefore Ofgem should not consider the availability of a larger number of products to be an end in itself. To be clear, we do not believe the range of MMO products needs to be expanded to include peakier products. Quite simply, wholesale markets facilitate the trading of standardised products that many parties want to trade. Forward products will not be sufficiently granular to match suppliers' load shape. Instead day-ahead and intraday markets are used by suppliers, like us, to fulfil this role. Even on Europe's most liquid wholesale electricity markets, such as Germany and Nordpool, forwards/futures trading is generally limited to the standard traded products and the vast majority of total liquidity is concentrated in key benchmarks such as calendar year baseload.

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 market is highly liquid because many parties want to trade in this time period. The market is much less liquid two years out because there is too much uncertainty this far out to warrant a significant amount of trading. In our view, the most significant contributor to near term market liquidity is the changing structure of the market; over the last few years we have seen an array of new small suppliers and generators (particularly non-controllable renewables) enter the market with a need to optimise in the short-term which has helped the market to flourish. By contrast, coal generating capacity has declined dramatically and forward dark spreads no longer make it attractive to hedge exposures on the further curve in the way that such generators used to do a few years ago.

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.

Centrica agrees that liquidity has improved but we do not believe it is possible to conclude that this is the result of the MMO. The data on 'OTC trading in baseload forward products' (figure 2) shows that the biggest increase in delivered volumes was in 2011 which was before the MMO was introduced. Furthermore, around 900 TWh was traded in 2011 which was the highest level in the entire time period apart from 2016 when around 1100 TWh was traded. Data on 'OTC trading in peak and off-peak forward products' (figure 3) shows a similar trend, although an increase in off-peak volumes, particularly those further down the curve, does appear to coincide with the introduction of the MMO. Data on 'Secure and Promote baseload products traded OTC' (figure 4) also confirms the same trend with a similar level of volumes being traded each quarter since 2011, apart from 2016 when volumes increase.

It is also useful to compare the liquidity of the UK market to other similar markets where no MMO has been introduced. The European Commission's most recent Quarterly Report on European Electricity Markets[4] shows the UK has comparable churn levels (at 4.8) to the Nordic markets (4.4) and France (3.6) which suggests that liquidity in GB is at a sufficient level to warrant the suspension of the MMO.

The greater liquidity of the German market reflects, in our view, factors which are not replicable in GB in the short term, such as a far higher level of cross-border interconnection capacity. Having said that, we would expect GB market liquidity to benefit over time as new interconnectors currently in construction come on line.

Aside from the conclusions Ofgem has drawn from the data, we consider that another area which would improve the analysis of the state of liquidity would be for Ofgem to review how much of the trading is taking place between the obligated parties as they seek to close their positons. This would provide Ofgem with a truer view of the benefits or otherwise of the MMO.

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?

Many of our comments on the impact of the market making obligation on liquidity have been covered in our response to question 4. In our view, the impact that the MMO is having on the market goes beyond an impact on liquidity. Broadly speaking, in benign market conditions, the MMO has not imposed an excessive financial burden on licensees although we would question whether any benefit has warranted the cost to obligated parties.

However, it has become clear in dramatically more volatile market conditions that a number of the fixed scheme parameters (bid-offer spreads, "fast market" rule, etc.) mean that the MMO is not operating as originally intended. Specifically, in the highly volatile conditions that we saw during last winter (and could well re-occur next winter given current indications), the impact of the MMO is to:

- concentrate forward liquidity in the MMO windows, often with discontinuous trading patterns and large price 'jumps' (rises or falls) between one window and the next;
- make normal price discovery difficult and at times virtually impossible;

[4] Quarterly Report on European Electricity Markets, Volume 10, Issue 1 2017.

- create ‘false liquidity’ and feed market volatility in an unhelpful way, as obligated parties seek to cover their losses and restore a ‘flat’ MMO book position as soon as possible;
- create sharp tensions between our compliance obligations under the MMO itself and our ‘fair pricing’ obligations under MAR/MAD1 and REMIT2 - these conflicting regulatory
- obligations are becoming increasingly difficult to manage and are placing our traders in an invidious position;
- impose upon smaller independent players increased market risk and/or increased risk premia in ‘sleeving’ arrangements with larger players acting on their behalf in the market;
- facilitate large unintended financial transfers from MMO parties to other large traders who do not face those obligations; and
- given the poor benefits case for the MMO in today’s market conditions, impose upon obligated parties wholly disproportionate costs and risks.

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 does not provide sufficient protection to obligated parties. The trigger of 4% is set too high as by the time the market has moved by this amount, a disproportionate level of cost has been incurred by MMO obligated parties.

We believe most traders would consider even a 1% price move to be substantial and as such we believe this would be a more proportionate trigger. Furthermore, the evidence shows that, at least under normal market conditions, it would have virtually no impact on the time that obligated parties market make.

We analysed each MMO Window for the six-month period between 1st February and 31st July for four MMO products (see table below) and assumed a Fast Market trigger of 1%. The data shows that a Fast Market would only have been triggered once for Month+1 baseload and peak products meaning that obligated parties would still have been obliged to be on-screen for almost 100% of the time.

Product	Period	MMO windows in period	Fast Market occurances	Probablility of Fast Market
Month + 1 baseload	1st Feb '17 to 31st Jul '17	258	1	0.4%
Month + 1 peaks	1st Feb '17 to 31st Jul '17	258	1	0.4%
Season + 1 baseload	1st Feb '17 to 31st Jul '17	258	0	0%
Season + 1 peaks	1st Feb '17 to 31st Jul '17	258	0	0%

Source: Centrica analysis of market data

An additional issue with the current Fast Market mechanism is that it is only applied within windows and not across windows in a given day. Some of the most substantial changes in prices are experienced when the second window opens (e.g. prices posted at the beginning of the second window can be 4% or 5% higher / lower than at the close of the first window) and this does not trigger a fast market. We believe that a more logical approach to the Fast Market rule is for it to be applied across the entire day.

The key problem with the 30MW volume cap rule is that it is arbitrary and applies to all obligated parties regardless of their size.

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

Small suppliers are best placed to answer whether the SMA has helped provide access to the market. For its part, Centrica does not have any major issues with the structure of the SMA and believes it is a generally positive mechanism for improving the conditions under which small eligible suppliers can access the market. That said, our main is observation that very few eligible suppliers have approached Centrica to request entering into a trading agreement: currently, we only have a small number of trading agreements in place with eligible small suppliers and have not traded any volumes in 2017. This would suggest that the attractiveness of the scheme for small eligible suppliers is limited.

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

There are a number additional external policy factors that Ofgem when assessing Secure and Promote. First, Ofgem's reform to the cash-out arrangements is seeing the introduction of more marginal cash-out. From November 2018, cash-out prices will be calculated from the most marginal 1MWh. This has the potential to substantially exacerbate volatility in the wholesale electricity markets, further increasing costs to obligated parties to an even more disproportionate level and way above the costs foreseen in Ofgem's impact assessment.

Second, we believe that the Market Making Obligation, with its fixed bid/offer spreads, is in inconsistent to European rules, REMIT and MAR in particular. This is because mandating obligated parties to post prices at a fixed bid/offer spread means that the prices posted may not reflect market fundamentals and therefore could leave traders to a hard choice between complying with the MMO or adhering to market integrity principles. Allowing some flexibility in the parameters (e.g. by allowing the bid/offer spreads to flex at times of volatility) could help overcome the policy's inconsistencies with market integrity rules.

Third, as we noted in the introduction, the CMA's conclusion that vertical integration does not have a significant impact on liquidity must urgently be addressed by Ofgem. Ofgem's concerns that the 'Big Six' were impeding liquidity were the basis for the policy and the dismissal of this hypothesis requires, at the very least, a reassessment of which companies should perform the MMO. This now is especially pressing given Ofgem's decision to remove the MMO licence obligation from EON/UNIPER meaning that an undue and disproportionate burden of the MMO is likely to fall on fewer and fewer market participants, including Centrica.

Finally, other long-running policy developments that Ofgem should continuously review the Secure and Promote Policy against are BREXIT, with the potential negative impact on liquidity, and the various decarbonisation policies both at GB and European level (e.g. the Clean Energy Package).

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

Centrica is firmly of the view that the policy should able to allow flexibility during certain market conditions (e.g. high volatility). This was also recognised by Ofgem as being important when it stated that "it is important to note that maintaining flexibility within S&P would be valuable, as it would allow the obligation to quickly adjust to the needs of market participants"[5]. However, the obligation has been designed in a non-flexible way that is unable to respond to market conditions.

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[5] See Ofgem 'Final Proposals for Secure and Promote' licence condition (published 12th June 2013), point 2.3, p. 14

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Given that timescales will not allow formal changes to licences by this winter, we believe that Ofgem should overcome this by issuing the type of letter it did in 2014 which exempted obligated parties from performing the MMO on certain days over the Christmas period. The letter should either suspend the licence condition for the winter period, or make some emergency temporary adjustments e.g. November to March to the parameters. If Ofgem chooses the latter, the threshold that triggers a Fast Market should be lowered from the current 4% to 1% and the bid/offer spreads widened by 4 times the current level.

Although this solution would not solve permanently the inherent rigidity of pre-set bid-offer spreads, it should be sufficient on an emergency basis to provide additional protection to MMO obligated parties with damaging liquidity. Concurrently, Ofgem should launch a wholesale review of the Secure and Promote policy to ensure an enduring solution.

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.

As an obligated party we are primarily able to comment on the costs rather than the benefits. Whilst we recognise that in most years the costs incurred were consistent with those estimated in Ofgem's Impact Assessment, the years when this occurred coincided with generally benign conditions. When market volatility increased towards the end of 2016, our costs substantially increased.

Indeed, the costs incurred in 2016 from market making were substantially above those forecasted in Ofgem's 'high case' scenario. We believe this level of cost is unacceptable, particularly without any form of compensation. Without repeating all of the detail of our responses to the previous questions, we believe such high costs arise from the inflexibility of the main parameters, in particular the Fast Market rules and bid offer spreads. Along with this response, we are also submitting a confidential annex to Ofgem providing full detail around these costs.

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?

As noted above, we believe it is essential that Ofgem undertakes wholesale review to examine whether such a market making obligation is still required and if it is, which policy would deliver it in the most cost-effective way.

The majority of the costs on obligated parties stem from the costs of closing an open position when an MMO bid or offer has been taken. The regulated MMO bid/offer spreads do not reflect market fundamentals so effectively offer a subsidised product to the market which have to be bought back by the obligated parties at the next best price. It is because of this that MMO obligated traders are essentially trading reluctantly and the liquidity is essentially 'false'.

Under the current scheme, there are a number of ways in which the current levels of liquidity could be maintained or improved at lower levels of cost, primarily by relaxing some of the parameters to better reflect market fundamentals. Of upmost priority is amending the Fast Market Rules as they do not currently sufficiently protect parties from volatility.

The Fast Market rule should be reduced from 4% to 1% and applied across the entire day rather than in each window. In addition, the mandated bid/offer spreads should be either widened or by introducing an algorithmic solution that will flex the mandated bid/offer spread at times of volatility.

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

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No