SCOTTISHPOWER

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Dear Matthew and Hannah,

Secure and Promote Review: Consultation

Thank you for the opportunity to provide views on behalf of ScottishPower on Ofgem's review of the Secure and Promote (S&P) policy.

We view the policy as having been broadly successful in meeting its objective of improving liquidity, measured in terms of fair market access, availability of products required for hedging and robust reference prices. Indeed, the recent growth in the number and market share of independent suppliers provides strong evidence that access to the wholesale electricity market is not constraining retail competition. The CMA's energy market investigation recognised the role of secure and promote in ensuring that there are no liquidity issues in the S&P mandated products while the policy is in place[1] and found no evidence of any detrimental impact on competition from vertical integration[2] or for any incentive or ability for input foreclosure[3] in the GB electricity sector.

Our main points in response to the consultation are set out below, with answers to the specific consultation questions set out in Annex 1:

- **Selection criteria for S&P licence obligations:** The current criteria for deciding which market participants should be subject to each of the obligations lack clarity and do not appear to be sufficiently robust or future-proof to meet the original policy intent. The recent decision to exempt a licensee from its MMM obligation following the re-structure of its generation and supply businesses – and the prospect that other companies may follow suit – raises questions about the sustainability of the S&P policy. If a small number of remaining obligated suppliers are left to shoulder the burden this could distort competition.

- **Credit and collateral:** We agree that the current arrangements for obligated licensees under the S&P policy are more appropriate than a one-size-fits-all approach. It is important that individual market participants develop their own credit risk management policies which reflect the risk appetite of their own investors.

[1] Liquidity annex of the CMA's final report
https://assets.publishing.service.gov.uk/media/576bcb4fe5274a0da30000d1/appendix-7-1-liquidity-fr.pdf
[2] VI chapter of the CMA's final report
https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf
[3] Foreclosure annex of the CMA's final report
https://assets.publishing.service.gov.uk/media/576bcb5740f0b66bda0000a8/appendix-7-2-foreclosure-fr.pdf

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- **Publication of additional SMA guidance:** We have often experienced protracted SMA negotiations due to insufficient engagement from the counterparty. The costs of this activity could be significantly reduced without impacting the policy objective if Ofgem were to publish guidance on the expected behaviours, with particular regard to what constitutes reasonable steps in progressing negotiations in a timely manner and in what circumstances the obligated licensee can abandon the process.

- **Distortions to competition:** As the costs of the MMM obligation become more material they can result in distortions to competition, both between obligated and non-obligated licensees and between obligated licensees (since larger businesses can better absorb the cost). As the benefits of MMM are enjoyed by all consumers, we believe all suppliers should contribute to the costs, to avoid such competitive distortions. In the longer term, we would urge Ofgem to consider the appointment of market makers by a competitive auction process, with the costs being recovered via a supplier levy, as the fairest and most proportionate solution to this issue.

- **Liquidity in "block" products:** Although we have been able to hedge the requirements of our supply and generation businesses for super-peak shape products in the forward OTC market[4], we recognise that improved liquidity in these products could be beneficial for all market participants and ultimately consumers. We believe that the most proportionate solution would be for Ofgem to secure voluntary commitments from a selection of parties on a bilateral basis, including the largest suppliers and generators, to submit either bid or offer trade orders in the required products at market prices during MMM trading windows. We have provided further details of how we believe this could work in Annex 2.

- **Review of maximum bid offer spread limits:** Since the EBSCR cash-out reforms, price volatility of super-peak products has increased, exacerbated by reduced system margins. We believe the limits on bid-offer spreads, particularly in peakload products, need to be reviewed, as limits set prior to March 2014 are unlikely to remain appropriate following implementation of the EBSCR reforms.

- **'Soft landing' prior to trading windows:** We think that there is merit in considering a 'soft landing' period in the first 5 minutes of the trading window whereby obligated licensees would be permitted to submit wider bid-offer spreads. At times of high market volatility, as seen 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.

We understand from the workshop hosted on 2 May 2017 that Ofgem plans to seek views on the policy in this consultation, with a view to identifying any initial changes for implementation ahead of this winter, but that it is considering a more fundamental review in 2018. We support this approach and look forward to engaging with you both on the quick wins and on the more strategic changes which we have proposed in our response.

I hope you find these comments useful. Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,

Rupert Steele

Rupert Steele
Director of Regulation

[4] As evidenced by transactions in 650MW of winter 2016/17 WD5 between April and September 2016 in trade data provided in our response to Q11 of the consultation. We believe that this volume would have been sufficient to have met the needs of independent generators operating a medium sized CCGT or thirty typical sized reciprocating plants or an independent supplier with around 1.4m domestic customers).

Annex 1

SECURE AND PROMOTE REVIEW CONSULTATION

SCOTTISHPOWER RESPONSE

The Supplier Market Access (SMA) obligation has been successful in providing a consistent minimum standard for Eligible Suppliers to obtain master agreements, credit, and access to trades at fair prices. We agree there is also evidence of wider benefits, such as Eligible Suppliers being increasingly able to trade in non-obligated products and other independent suppliers (not registered as Eligible Suppliers) being able to trade their requirements without reliance on regulatory obligations.

The Mandatory Market Making (MMM) obligation has been successful in providing firm bid and offer trade orders and robust reference prices in a range of products required for hedging purposes. In principle, it strikes a pragmatic balance between minimising costs and maximising liquidity. However, as the costs incurred become more material they can result in distortions to competition, both between obligated and non-obligated licensees and between obligated licensees (since larger businesses are better able to absorb the cost). As the benefits of market making are enjoyed by all consumers, we believe all suppliers should contribute to the costs, to avoid such competitive distortions. In the longer term, we would urge Ofgem to consider the appointment of one or more market makers by a competitive auction process. This could be done on a pay-as-clear basis, with the bid costs being recovered via a supplier levy, as the fairest and most proportionate solution to this issue.

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 consider that prices for forward delivery both within and outside MMM trading windows are generally robust and provide a fair reflection of the underlying supply and demand for the contracts at each point in time.

Consumers should take confidence that the Regulation on Market Integrity and Transparency (REMIT) ensures that market prices are robust given that: (i) it has EU-wide applicability, ensuring consistency of approach; (ii) it clearly defines and explicitly prohibits market abuse; (iii) it obliges firms professionally arranging transactions to report suspicious transactions; and (iv) it provides for effective and timely public disclosure of inside information by public participants. These four purposes are strengthened by the significant penalties that may be imposed on parties found in breach of REMIT, which should further comfort consumers that a strong deterrent effect is a key part of REMIT and that any civil and criminal penalties will be proportionate to the breach.

While recognising that an appropriate balance needs to be struck between costs incurred and liquidity provided, we believe that the currently mandated bid-offer spread limits, particularly in volatile peakload products, are overly tight during periods of extreme market price volatility (as observed during Q4 2016). It will therefore be important for Ofgem to assess the appropriateness of the spread limits. In doing so, it will need to consider whether the obligated market makers have all consistently incurred trading losses and whether the benefit to consumers of the differential in liquidity between the currently mandated limit and an alternative wider limit offsets this cost.

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.

Since the introduction of the licence condition, we have observed greater availability of the products needed to hedge (particularly in peakload contracts and in tenors beyond S+1), at reduced bid-offer spreads, during the trading windows than was previously the case. While overall churn has only marginally increased, there has been an improvement in availability of products required to hedge, combined with reduced bid-offer spreads and fair access to trading master agreements and credit. These are likely to represent much more important factors in achieving the wider policy objective of improving liquidity in support of competition by new-entrants in the retail market.

We recognise that the availability of products outside of the trading windows is much more limited. However, we do not see this as a barrier to participation in the market which results in orders from independent suppliers, or even participants such as ourselves, going unfulfilled. We consider that the increased costs of extending the windows (which we view as being proportional to the extension) would outweigh the likely benefits (which we expect to be incremental at best). Furthermore, we note that in the Liquidity annex of its Final Report (para 90), the CMA stated "… it is probably sufficient for most industry participants to know that there will be points every day when they can trade a set of products that accounts for the majority of trading, even if they cannot trade them all the time."

We are aware of proposals to extend the window but mitigate the impact on obligated parties by reducing the compliance target (e.g. 50% compliance during 4 hour daily windows or annual targets). While not opposing such proposals in principle, we do not view extension of the windows to be a priority for the majority of market participants and have concerns that they could be gamed to avoid compliance during volatile periods to the detriment of the policy objective. Furthermore, we believe that compliance monitoring could prove challenging, both for obligated licensees and the regulator. Rather, we see greater value in terms of cost saving for both market makers and market participants from deeper liquidity for shorter periods versus thinner liquidity for longer periods.

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.

Our observation is that the near-term market is sufficiently liquid to meet the needs of all market participants, including ourselves. The availability of continuously traded forward and spot markets and day-ahead auctions which implicitly link GB to adjacent markets via the market coupling process, provide ample opportunity to trade to refine overall and shape requirements.

We have observed increased reliance on these near-term markets for a number of reasons, including:

- Greater incentives to balance in individual settlement periods, arising from tighter system margins and EBSCR cash-out reforms;
- Growth in intermittent generation capacity, which has resulted in increased trading requirements closer to delivery as volume forecasting errors are reduced; and
- Increased unreliability of ageing coal-fired plants, which has resulted in increased trading requirements closer to delivery as unplanned outages occur.

While we note that few if any independent suppliers have directly contracted with exchanges, we are satisfied that they have effective opportunities to do so and can indirectly access near-term liquidity by contracting with members of the exchanges including through the SMA obligation.

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 broadly agree with Ofgem's high-level analysis of the state of 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?

Market liquidity has been underpinned by the MMM obligation during periods of both benign and volatile market conditions. In benign market conditions, while liquidity cannot be attributed solely to the policy (and has been generally negatively impacted by the market exit of financial players as result of more onerous financial regulations), the policy has provided continued availability of robust reference prices at reasonable bid-offer spreads. In more volatile conditions, as observed in Q4 2016, the continued availability of trade orders in forward products provided by obligated licensees resulted in greater trade volumes as prices trended upwards and subsequently back down again.

The key difference between the periods of benign and volatile conditions has been the cost incurred by the obligated licensees, as Profit and Loss (P&L) costs and trade volumes are highly correlated to price volatility. It is no coincidence that the P&L costs we incurred in discharging the obligation during 2016, when extreme price volatility was observed in Q4, were materially higher than those incurred in each of the first two years in which the S&P policy was operational.

All stakeholders in the MMM obligation, Ofgem, MMM obligated licensees and other market participants, should take confidence from the operational efficacy of the obligation as evidenced by high levels of compliance observed during Q4 2016.

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 the fast market and volume cap rules are intended to provide an important control to prevent excessive costs being incurred by obligated licensees during periods of volatile market conditions, while ensuring that liquidity is maintained for the benefit of all market participants.

As the fast market rule is designed to control excessive costs being incurred by obligated licensees, an analysis of the comparatively rare usage should be undertaken to ensure that the threshold is set at an appropriate level.

The volume cap has been more frequently used as price volatility has increased, notably in Q4 2016. Its availability has been a vital tool in minimising costs yet our observation is that its deployment has rarely impacted liquidity due to the number of market makers, i.e. up to 18 x 10MW trade orders have been available across up to six obligated licensees in trading windows since the introduction of S&P in March 2014. We would caution against proposals to increase the volume cap unless evidence of meaningful benefits can be demonstrated.

Furthermore, the limited impact of individual volume caps on overall liquidity adds further weight to our view that concentrated liquidity during shorter windows is preferable to more limited liquidity and longer windows.

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

The Supplier Market Access (SMA) obligation has been successful in providing a consistent minimum standard for Eligible Suppliers to obtain master agreements, credit and access to trades at fair prices. There is also evidence of wider benefits such as that Eligible Suppliers are increasingly able to trade in non-obligated products and that non-Eligible Suppliers are able to trade their requirements without reliance on regulatory obligations.

Our own experience is that the obligation may have had a more limited impact in helping to secure trading master agreements as we already had appropriate processes in place prior to the policy being implemented. We had already secured five agreements with parties which later became Eligible Suppliers and following implementation of the obligations have concluded a further five agreements. However, we recognise that other obligated suppliers may have previously had less well developed processes and consequently their experiences may differ.

As demonstrated in our quarterly compliance reports, we have also observed a reduction in trades with Eligible Suppliers in SMA obligated products, but an increase in both trades with Eligible Suppliers in non-obligated products and with independent suppliers not registered as Eligible Suppliers in both obligated and non-obligated products. This evidence would suggest that independent suppliers are increasingly accessing the market via a constructive commercial relationship which works for both parties rather than relying solely on regulatory obligations which may be unnecessarily complex or inflexible for their specific requirements.

Regrettably, we have regularly experienced protracted negotiations regarding master agreements due to a lack of adequate engagement from the counterparty. This is evidenced by eight ongoing negotiations which commenced as early as April 2015 in which the counterparties have failed to respond following compliance by ScottishPower with the relevant milestone, despite repeated prompts by us to do so. It is our view that this is an unintended consequence of the SMA obligation that is likely attributable to the one-sided nature of the obligations it has imposed upon obligated licensees. We believe that the costs of undertaking this activity could be significantly reduced without impacting the success of the policy objective by publishing guidance on the expected behaviours of all parties. The guidance could set out what constitutes reasonable steps in progressing negotiations in a timely manner and in what circumstances the obligated licensee should be able to abandon the process if appropriate engagement from the counterparty is not forthcoming.

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

We have previously experienced circumstances in which the Inside Information Disclosure obligations of REMIT have conflicted with the MMM obligation of the S&P licence condition, i.e. inside information is identified which needs to be disclosed before trade orders can be submitted at the commencement of a trading window. We have developed automated systems to mitigate this issue, and the closure of ageing plants which were susceptible to unplanned outages has also reduced the frequency of such issues, but the circumstances for potential conflict remain.

Since the EBSCR cash-out reforms were implemented, price volatility of super-peak products has increased, exacerbated by reduced system margins. We believe the limits on the bid-offer spreads, particularly in peakload products, need to be reviewed as the limits identified as being appropriate prior to March 2014 are unlikely to remain appropriate following implementation of the EBSCR reforms. The further cash-out reforms due to be implemented in winter 2018/19 (PAR1 pricing and £6k/MWh VoLL) suggest that a review will also be required next year.

Since the S&P policy was designed in 2013 and implemented in 2014, the role of conventional dispatchable generation has changed considerably in the generation market. These plants previously operated at relatively high load factors in response to market conditions but have been increasingly displaced in the merit order by: (i) the growth of renewables; and (ii) the growth of imports, which are not subject to the UK's Carbon Price Support tax and which are exempted from a range of network charges, across existing and new interconnectors. Furthermore, these conventional plants are being increasingly contracted on a forward basis for ancillary services with the System Operator which prevent their re-dispatch in response to evolving market conditions. Therefore, it appears to be overly simplistic to assume that these plants are available for sales of energy in the forward wholesale market in the mandated product range in the S&P policy, and that their operators are therefore the most appropriate obligated licensees, as they will frequently be out-of-merit or contractually unable to meet the necessary production schedule.

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

In principle we recognise that there could be benefits to amending aspects of the licence condition in some circumstances. However, regulatory certainty is important to investors and clarity would be required on precisely what flexibility and in what circumstances it was intended to operate. We look forward to seeing any detailed proposals which Ofgem seeks to make in a future consultation exercise.

Mandatory market making obligation in supply licence

Although Ofgem took the decision to place the MMM obligation in the generation licence, all the companies caught by the obligation were vertically integrated and the obligation could equally well have been placed in the supply licence. Indeed, several of the four criteria that Ofgem used to justify the selection companies to be covered by the obligation[5] arguably had more to do with their supply activities than their generation activities:

a) market share in the domestic segment of the supply market;
b) vertical integration;
c) trading capabilities; and
d) effectiveness of the intervention.

Obligated parties will be better able to recover the costs of the MMM obligations from markets in which the obligated parties collectively have a high market share. For example, if all of the 'Big 6' suppliers were obligated, the fact that they have a greater than 80% share of the domestic retail market suggests that they may be able to pass on a reasonable proportion of the costs to these customers without too adverse an impact on market share. Conversely, with a lower share of the generation market, there is a reduced prospect of passing on costs without a significant impact on market share.

[5] Ofgem's final S&P proposal consultation dated June 2013 para 2.8 (page 16) https://www.ofgem.gov.uk/ofgem-publications/39302/liquidity-final-proposals-120613pdf

Accordingly, there is a risk that major suppliers who are presently obligated licensees in respect of the MMM obligation, and whom the policy intended to provide the service, could apply for disapplication in the event of their exit from the generation market. Indeed, the recent decision to exempt a company with a major supply business from the MMM obligation following the divestiture of its generation business illustrates this point. The likelihood of further exemptions as other major suppliers re-structure or exit the generation market, leaving the few remaining vertically integrated suppliers to shoulder a disproportionate burden, casts doubt on the sustainability of the policy. We would urge Ofgem as a priority to consider introducing an equivalent supply licence condition to ensure that the policy remains sustainable. This could be introduced to complement the existing generation licence condition or to replace it wholly.

Allied to the above, Ofgem recently stated that obligated parties may apply for removal of all or part of the licence condition, with any decision to remove Schedules A, B or C based on the following factors:

a) any significant and sustained changes in the generation market share or generation output of a company group, taking into account its relative market share and overall size;

b) an indication that an existing S&P licensee will face disproportionate costs and risks in continuing to meet the licence condition, or that a potential new S&P licensee could meet the costs and risk proportionately; and

c) the sustained successful achievement of the objectives of this licence condition.

In addition it stated[6] that a fourth criterion would be applicable exclusively to Schedule B (the MMM obligation):

d) any significant and sustained changes in the domestic supply market share or volume supplied of a party, taking into account its relative domestic market share and size.

We assume that the reference to generation market share and output in point (a) was motivated by the fact that the obligation sits in the generation licence. Were Ofgem to include an obligation in the supply licence, its criteria for considering requests for exemption could more easily take into account domestic retail market share, as envisaged as the core criterion for selection in point (d).

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 observed a number of costs and benefits of the policy both in terms of our role as an obligated licensee and as a broader market participant.

<u>Costs</u>

The financial costs we have incurred in our role as a SMA and MMM obligated licensee fall into three categories: (i) additional employee headcount; (ii) additional external service costs; and (iii) additional trading costs. The background to how these additional costs have arisen and our estimates of their magnitudes are discussed below:

[6] Decision letter dated 30 Nov 2016 on its decision to exempt E.On following its re-structure: https://www.ofgem.gov.uk/system/files/docs/2016/11/e.on_uk_special_condition_aa_letter.pdf

i. **Additional employee headcount:** As a direct result of being selected as an obligated licensee, we have incurred additional costs in employing extra resources to undertake the activities, independently verify compliance and provide management oversight. Specifically, ahead of the obligation going live we employed one extra contract negotiator to process trading agreement applications and manage credit risk, one extra trader to respond to SMA trade requests and undertake MMM activities, two extra analysts to monitor the activity and prepare the quarterly compliance reports for submission to Ofgem and two extra analysts in our Systems team whose role is to provide the necessary systems support to undertake the activities. Furthermore, while we did not take on extra employees in our compliance team which independently verifies the activities, extra demand has been placed on the existing resource which represents an opportunity cost. It has also been necessary to dedicate significant management time both to set up the processes in support of this activity and on an ongoing basis to provide adequate management oversight including to respond to information requests received from Ofgem. In aggregate, we have estimated all of these costs at £400k per annum.

ii. **Additional external service costs:** As a direct result of being selected as an obligated licensee, we have incurred additional costs from contracting with external service providers for end-of-day reports and an automated bid-offer spread tool as well as for a dedicated internet connection for our trading desk to boost resilience to better meet compliance targets. In aggregate, we have estimated these costs at £✂k per annum.

iii. **Additional trading costs:** As a direct result of being selected as an obligated licensee, we have incurred additional costs both from brokerage fees on the incremental MMM trading volumes and on reversing out of trades for which there was otherwise no underlying requirement across our businesses. It is important to recognise that annually ScottishPower supplies much greater volumes than it generates and that in any case its generation assets may not be available for sales of forward energy in the mandated product range due to: (i) CCGT and hydro plants frequently being out of merit or unavailable due to maintenance outages or finite water stocks; (ii) CCGT and hydro plants frequently being contracted for the provision of ancillary services to the System Operator which prohibit output being re-scheduled irrespective of changing market conditions; or (iii) onshore and offshore windfarm output being intermittent in nature, with limited output predictability over the timeframe of up to two and a half years ahead of delivery which is relevant to the MMM obligation. Consequently, offers made under the MMM obligation frequently result in a financial exposure, rather than meeting a physical sales requirement from our generation business - as some stakeholders mistakenly assume is the case for vertically integrated energy firms. In aggregate, we have estimated these brokerage and P&L costs at £✂m in 2014, £✂m in 2015 and £✂m in 2016.

Benefits

Since the introduction of the policy we have observed greater liquidity in peakload contracts beyond the first season ahead of delivery. This has manifested itself in reduced bid-offer spread costs being incurred by our supply and generation businesses in hedging a subset of their trading requirements. We have estimated these benefits at up to £✂m across the three year period from 2014 to 2016.

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 recognise that there is a balance to be achieved in considering any policy amendments between the impacts on cost and liquidity. We have therefore focussed on two proposals which we consider would be in the overall interests of consumers:

<u>Proposal one: SMA negotiations</u>

As outlined above, we have regularly experienced protracted negotiations due to the lack of adequate engagement from the counterparty. We believe this is likely to be attributable to the one sided nature of the SMA obligation. Accordingly, we think the costs of undertaking this activity could be significantly reduced without impacting upon the success of the policy objective by publication of guidance by Ofgem on the expected behaviours of all parties, with particular regard to what constitutes reasonable steps in proceeding negotiations in a timely manner and in what circumstances the obligated licensee can abandon the process if appropriate engagement from the counterparty is not forthcoming.

<u>Proposal two: Liquidity in block products</u>

We are not convinced that the lack of liquidity in super-peak shape products is acute as some parties have suggested. Although we agree that improved liquidity in these products could be beneficial for all market participants and ultimately consumers, we note that we have been able to adequately hedge the requirements of our supply and generation businesses for super-peak shape products in the forward OTC market. As set out in Annex 2, the volumes of super-peak product we were able to procure would have been sufficient to meet the hedging needs of independent generators with a medium sized CCGT (or up to thirty typical sized gas reciprocating plants) or independent suppliers with around 1.4m domestic customers.

In assessing any proposal to extend the product range in the MMM obligation (e.g. to include say WD5 and/or WD6 for key durations up to a year ahead of delivery), Ofgem would need to balance the costs of such intervention (in terms of further distortions to competition as risk is transferred from one set of suppliers to another) against the benefits. In assessing the benefits, Ofgem would need to consider how much of the problem experienced by suppliers in meeting their block product requirements has been accounted for by inadequate market liquidity or alternatively to shortcomings in their individual risk management processes. (E.g. a supplier selling year-ahead energy to consumers but pursuing a shorter-dated hedging programme may have incurred windfall losses in Q4 2016 as volatile prices were observed following the introduction of EBSCR reforms and tighter system margins.)

We believe that the shortcoming in liquidity in niche products such as super-peak blocks, insofar as it exists, reflects the fact that market participants (large and small, generator and supplier, incumbent and new-entrant, transmission and distribution connected) do not regularly post their orders in the marketplace despite there being significant demand for trades in such products. The solution to this issue is not more regulation but for all parties to play a constructive role in contributing to market liquidity.

Therefore, we believe the most proportionate solution would be for Ofgem to bilaterally secure voluntary commitments from a selection of parties, including the largest suppliers and generators, to submit either bid or offer trade orders in the required products at market prices during MMM trading windows. This proposal would benefit all market participants seeking to trade these niche products by providing:

- availability of bid and offer trade orders on a twice daily basis;

- robust reference pricing; and
- a route to the wholesale electricity market for embedded generators who previously focussed on Triad management activities and who are concerned about market access following changes to charging arrangements;

without imposing material additional costs on obligated parties, further distorting competition.

Trade in block products requires natural buyers and sellers, thus large generators, particularly operators of dispatchable coal and gas capacity, have a key role to play in this aspect of the market. We have provided further details of how we believe this could work in Annex 2, and would welcome being involved in delivering such a commitment this winter and beyond. Such a solution could conceivably be implemented ahead of this winter; we do not believe, however, that such early implementation would be realistically possible were licence changes to be pursued instead.

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

Competitive distortions

The costs incurred by obligated licensees in discharging the MMM obligation are material and result in distortions to competition, both between obligated and non-obligated licensees and between obligated licensees with different-sized operations from which to recover the cost of the obligation. As the benefits of market making are enjoyed by all consumers, we believe that all suppliers should contribute to the costs to avoid such competitive distortions.

The table below illustrates the magnitude of the competitive distortion between obligated licensees of differing sizes, assuming an annual market making cost per obligated party of £5 million.

Company	Generation			Supply		
	Total generation (TWh)	Cost of £5m annual S&P MMM obligation (£/MWh)	Cost relative to largest obligated competitor (%)	Number of SVT customers	Cost of £5m annual S&P MMM obligation (£/SVT customer)	Cost relative to largest obligated competitor (%)
Centrica	23.6	0.21	309%	6,639,056	0.75	100%
EDF Energy	73.0	0.07	100%	1,943,277	2.57	342%
E.On	19.7	0.25	371%	3,170,499	1.58	209%
Npower	46.1	0.11	158%	1,737,642	2.88	382%
ScottishPower	13.0	0.38	562%	1,541,307	3.24	431%
SSE	22.5	0.22	324%	3,864,044	1.29	172%

Source: 2016 Consolidated Segmental Statements and Ofgem data on Standard Variable Tariffs published on 14 December 2016

In the longer term, we would urge Ofgem to consider the appointment of one or more MMM obligated parties by a competitive auction process, with the costs being recovered via a supplier levy, as being the fairest and most proportionate solution to this issue.

Selection criteria

The current selection criteria for deciding which market participants should be subject to each of the obligations lack clarity as they cite general considerations but provide no specific objective tests. This does not appear to be sufficiently robust or future-proof to meet the original policy intent, as the industry is undergoing rapid change. In particular, re-structures of companies and their entries to and exits from individual sectors need to be adequately recognised in any future S&P selection decision. We have already seen a decision to remove the MMM obligation from one licensee following a re-structure of its operations and can see circumstances developing where others may follow in seeking disapplication. This could risk leaving the costs of the policy being inversely borne by the smallest of the large generators and suppliers.

We view the role of the SMA obligation as governing the sale of wholesale power on fair terms to Eligible Suppliers and believe that it should be applied only to large generators. In particular factors such as vertical integration and supply market share are not relevant to this activity. Accordingly, an appropriately objective test for inclusion would be that the SMA obligation applies only to generators with at least 1GW of dispatchable plant at 1 October in the preceding year.

Conversely, the MMM obligation results in costs being incurred by the obligated licensee which can only be recovered by suppliers directly from consumers through retail prices. (See our response to Question 9 above.) In the absence of an industry-wide levy across all suppliers and in the context of Ofgem's previously stated position of "sticky customers" being a significant factor in its selection criteria[7], it would therefore appear appropriate to impose the obligation via a supply licence condition only on large suppliers with high numbers of SVT customers. Accordingly, an appropriately objective test for inclusion would be that the MMM obligation applies only to suppliers with at least 1m customers (or SVT customers) at 1 October in the preceding year.

<u>'Soft landing' prior to trading windows</u>

We have on occasion observed circumstances in which a 'soft landing' immediately prior to the trading window would be beneficial to all market participants. At times of high 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. This has resulted in MMM obligated licensees placing trade orders in the contract such that the best bid was above the best offer at the start of the trading window. We think that there is merit in considering a soft landing period in the first 5 minutes of the window whereby obligated licensees would be permitted to submit wider bid-offer spreads.

<u>Gross bidding activities</u>

We note the reference to stakeholder feedback on the usefulness of gross bidding activities on the day-ahead auctions in the consultation and also view it in the context of Ofgem's guidance on the prohibition of market abuse under REMIT as published in its open letter on 8 September 2015[8], specifically that on market manipulation. While we recognise that the practice of gross bidding was motivated by a genuine willingness to inject increased liquidity by vertically integrated parties seeking to dis-aggregate generation and supply volumes, we are not convinced that the practice provides significantly greater trading opportunities nor that it reflects genuinely increased market liquidity. In any event, in the light of the closure of Longannet, ScottishPower has ceased gross bidding activities and presently has no plans to re-start them.

[7] Para 2.8 https://www.ofgem.gov.uk/ofgem-publications/39302/liquidity-final-proposals-120613pdf
[8] https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/20150814_remit_open_letter_september_2015_0.pdf

Annex 2

**SECURE AND PROMOTE REVIEW CONSULTATION–
LIQUIDITY IN "BLOCK" PRODUCTS**

1. Introduction

This annex provides additional information in support of our response to Question 11. Section 2 summarises ScottishPower's experience of liquidity in block products and why we think that the lack of liquidity may not be as acute as some parties have suggested. Section 3 provides more detail on our proposed 'voluntary commitments' approach to improving liquidity in these products.

2. Experience of liquidity in block products

As noted in our response to Question 11, ScottishPower has historically been able to adequately hedge the requirements of its supply and generation businesses for super-peak shape products in the forward OTC market.

In support of this statement, Table 1 provides a summary of the trades transacted by ScottishPower in the forward winter 2016/17 WD5 contract between April and September 2016. Further trades were transacted to refine the hedging requirement closer to delivery, in forward, day-ahead auction and spot transactions, both in: (i) shorter dated contracts, e.g. durations of individual quarters, months, weeks and days; and (ii) bespoke shapes, e.g. two-hour periods such as 5b and individual settlement periods.

Table 1 - Trades transacted by ScottishPower in the forward winter 2016/17 WD5 contract between April and September 2016

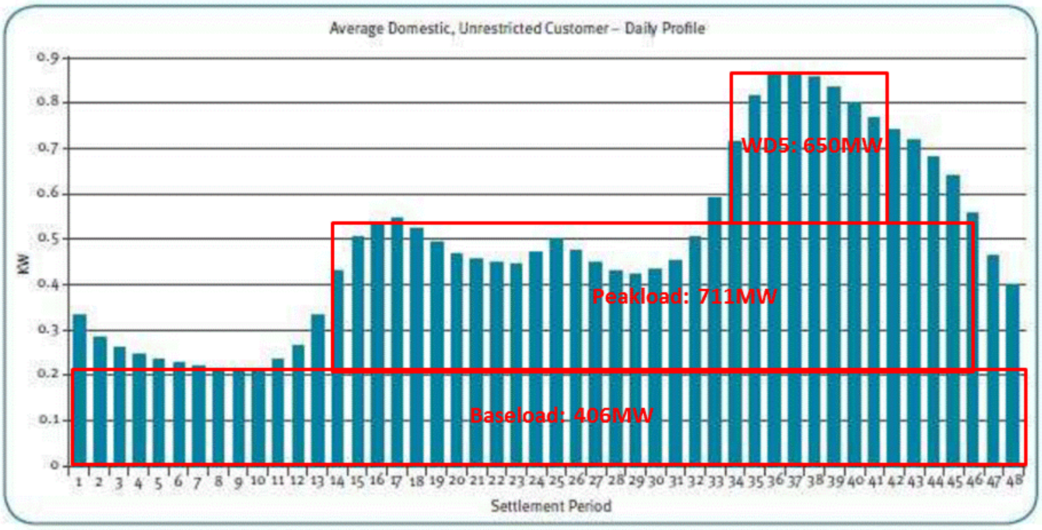
Month	Apr	May	Jun	Jul	Aug	Sep	Total
Number of trades	✂	✂	✂	✂	✂	✂	✂
Gross volume (MW)	✂	✂	✂	✂	✂	✂	✂

We estimate that the volume traded by ScottishPower last summer in the Winter WD5 contract would have been sufficient to have met the needs of:

- **Independent generators** with a medium sized CCGT or up to thirty typical sized gas reciprocating plants; or

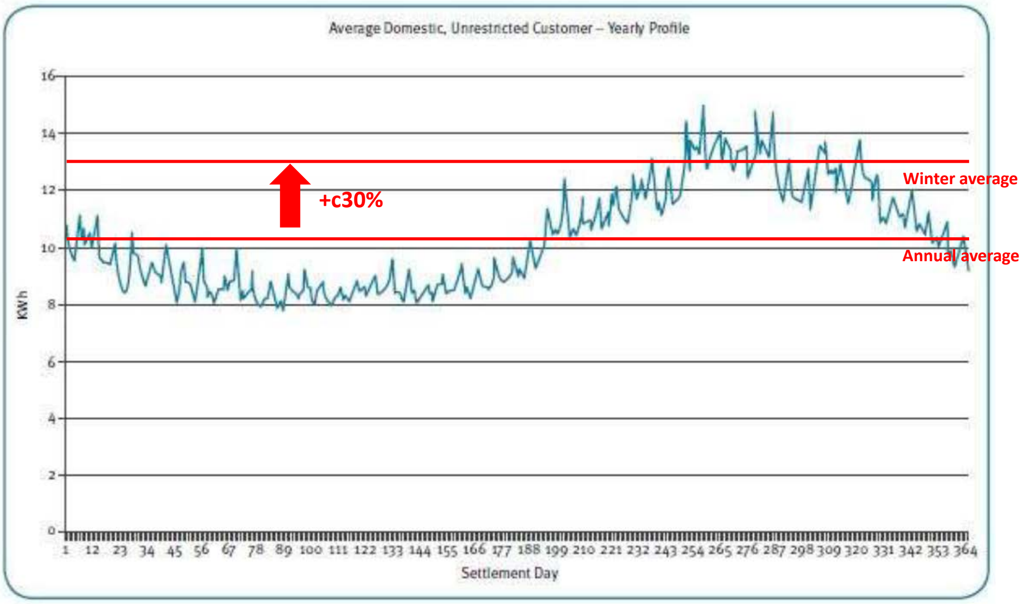
- **Independent suppliers** with around 1.4m domestic electricity customers based on P1 customer profile, as demonstrated in charts 1 and 2 below. The profile in chart 1 implies that the annual average requirement of a single customer of this profile has a peak demand of 0.87kW per customer, which can be met by purchases of 0.2kW of baseload, 0.35kW of peakload and 0.32kW of WD5, implying that 650MW of WD5 (aggregated with purchases of 406MW of baseload and 711MW of peakload) is equivalent to over 2m customers. As P1 demand is heavily weighted towards winter consumption, as highlighted in chart two, we estimate that a purchase of 650MW of winter WD5 is sufficient to meet the needs of around 1.4m customers across the winter, recognising that more or less volume will be required as demand varies on individual days throughout the winter.

Chart 1 – Average intra-day P1 domestic consumption profile



Source: Elexon standard intra-day P1 profile with overlays provided by ScottishPower.

Chart 2 – Average inter-day P1 domestic consumption profile



Source: Elexon standard inter-day P1 profile with overlays provided by ScottishPower.

In summary, we believe ScottishPower's experience of trading the super-peak shape products suggests that there was sufficient liquidity in the market for ScottishPower to adequately hedge its supply and generation requirements. The volumes we were able to access would have been sufficient to meet the needs of a significant number of small to medium independent suppliers, suggesting that the lack of liquidity may not be as acute as some have suggested.

3. ScottishPower proposal for 'voluntary commitments'

ScottishPower is proposing that in order to improve liquidity in 'block' products, voluntary commitments could be received by Ofgem on a bilateral basis from a selection of parties, including the largest suppliers and generators (see our response to Question 11 in Annex 1). The parties would commit to submit either bid or offer trade orders (at their choice in each trading window) at market prices during MMM trading windows. This Annex provides more detail on how this might work.

Scope

1. All generators with at least 1GW of dispatchable plant at 1 October in the preceding year.

2. All suppliers with at least 1 million SVT customers at 1 October in the preceding year.

Commitment

Each licensee commits that it or its nominated non-licensed trading representative will submit either a bid or offer trade order in the relevant product during each trading window.

Relevant products

	WD5	WD6
M+1	Bid (Offer) Trade order to be submitted within [5%] of the best bid (offer) order	Bid (Offer) Trade order to be submitted within [5%] of the best bid (offer) order
M+2	Bid (Offer) Trade order to be submitted within [5%] of the best bid (offer) order	Bid (Offer) Trade order to be submitted within [5%] of the best bid (offer) order
Q+1	Bid (Offer) Trade order to be submitted within [5%] of the best bid (offer) order	Bid (Offer) Trade order to be submitted within [5%] of the best bid (offer) order
S+1	Bid (Offer) Trade order to be submitted within [5%] of the best bid (offer) order	Bid (Offer) Trade order to be submitted within [5%] of the best bid (offer) order

Suspension of commitment

As existing Schedule B conditions regarding fast market and volume cap rules.

Quarterly compliance reports

Each licensee to voluntarily provide information on trades transacted and on any failures to submit trade orders under the undertaking.

ScottishPower
19 September 2017