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Secure and Promote Review: Consultation

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, storage, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

We welcome Ofgem's timely review of the Secure and Promote Licence Condition, which we believe should facilitate an appropriate assessment of the impact of the obligation on obligated parties, small suppliers and the wholesale market. Furthermore, it is important that the review also includes a robust assessment of the extent to which the obligation is meeting Ofgem's original policy objectives; and whether these objectives remain valid in today's market.

Summary

- It is not clear whether the market making obligation (MMO) policy has had a materially positive impact on the operation of the wholesale market. However, it has imposed significant costs on EDF Energy as an obligated party.
- We do not agree that the mandated bid-offer spreads have "led to improved reference prices" as Ofgem states. Mandated spreads prevent proper price discovery meaning that the resulting prices will likely be less reflective of market fundamentals, the cost of which is borne by consumers.
- Ofgem's MMO rules do not protect obligated licensees from incurring significant costs during periods of high market volatility (e.g. as experienced in late 2016). In particular, the use of mandated spreads prevents the normal process of price discovery during such periods.
- The absence of liquidity outside of the MMO windows should be a concern because it has affected the ability of the market to operate effectively, and combined with other aspects of the MMO means traders are less willing or able to make markets naturally.
- The current design of the fast market and volume cap rules do not allow obligated parties to fully and effectively manage the risks from the MMO during periods of market volatility.

- The original rationale for introducing a MMO, and for selecting the obligated parties, was driven by concerns that vertically integrated parties benefited from a natural hedge that limited their incentive to make power available to other parties. However, the CMA's 2016 market investigation concluded that this concern was unfounded. Ofgem's review should revisit the original policy objectives to see whether they remain valid.
- In addition to considering the volumes traded by market makers, Ofgem's review should look at with whom obligated parties are trading. We believe that obligated parties predominantly trade among themselves, in particular to close out each obligation window with zero physical exposure. Such trading has little direct benefit to entrants and non-obligated parties, and indeed little indirect benefit in periods when mandated spreads undermine price discovery.
- Ofgem should withdraw the market making obligation, or at least ensure that (a) it does not impose material costs/risk on obligated parties and (b) that the choice of obligated party is fair in light of Ofgem's current legitimate policy objectives.
- Should Ofgem retain an MMO, given that concerns about vertical integration are no longer a valid driver of Ofgem's policy it would be discriminatory not to review the criteria for selecting obligated parties. Obligating all generators and suppliers over a certain size would be a sensible way forward. Increasing the number of obligated parties (from effectively four currently) would also improve the price discovery process, particularly if spreads were no longer artificially constrained as we recommend.
- The Supplier Market Access (SMA) rules largely replicate a commitment EDF Energy already had in place. We have not identified any need for change.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Ian George on 01452 654498, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

Paul Delamare
Head of Customers Policy and Regulation

Attachment

Secure and Promote Review: Consultation

EDF Energy's response to your questions

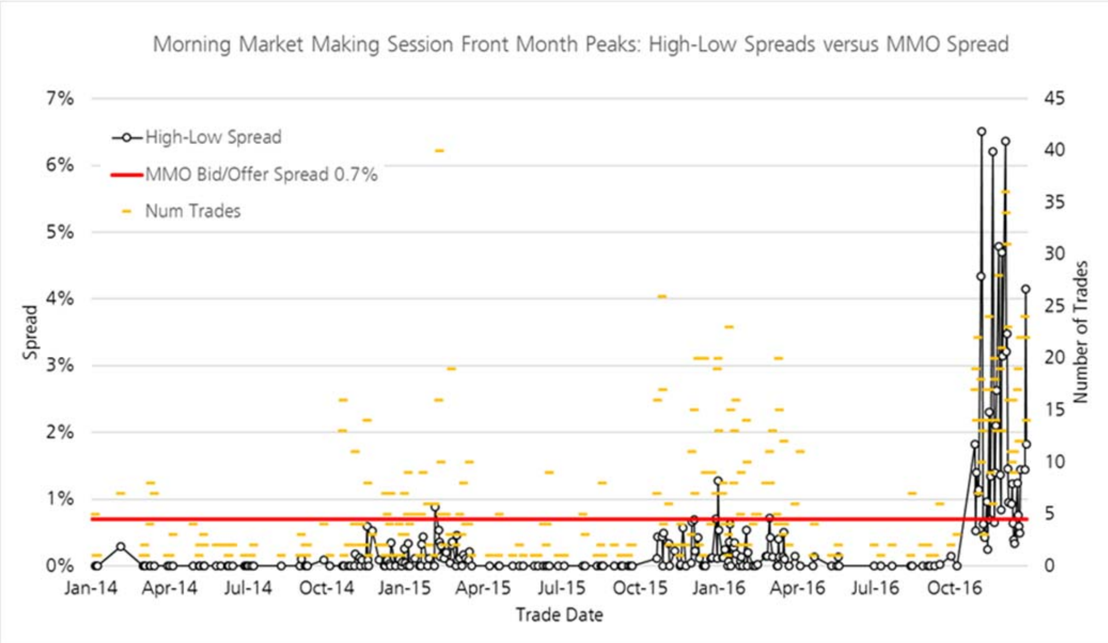
Q1. Please comment on whether you think prices for forward delivery are robust. Please refer to prices in and out of the market making windows and comment on the current mandated bid-offer spreads.

The observed narrowing of spreads on market making products since the introduction of Secure and Promote is not surprising given the mandated nature of spreads under the MMO.

We note Ofgem's comments regarding the upward trend in spreads in non-mandated products and the conclusion Ofgem draws from this (that in the absence of Secure and Promote narrower spreads would likely have remained unavailable both inside and outside the windows). We do not agree with this conclusion. As there is relatively little demand for the non-mandated products the market for them is less liquid (spreads and liquidity are related to each other) and as a result spreads will be higher.

We agree that in benign market conditions market participants can generally have confidence in the robustness of prices under the MMO as it is more likely that freely floating spreads trade within the mandated range. However, we remain concerned that during periods of volatility the binding nature of the MMO spreads interferes with the natural process of price discovery. In a normal market, volatility is characterised by wider spreads as market participants more cautiously approach price discovery. Spreads are initially wide but will progressively narrow as the market reaches equilibrium.

The restrictive nature of the MMO spreads was clearly evident during the high levels of market volatility experienced in Q4 2016. As illustrated in the graphs below, for most of the days prior to Q4 of 2016 obligated parties were able to manage the MMO within the existing caps. However, during Q4 2016 there were a number of days where the gap between market trades was much higher, exposing obligated parties to high level of risk as they were unable to effectively manage positions. While the graphs are for specific example products in the morning sessions, the same pattern could be seen for any product delivering in winter 2016, in both morning and afternoon sessions:


Morning Market Making Session Front Month Peaks: High-Low Spreads versus MMO Spread
High-Low Spread
MMO Bid/Offer Spread 0.7%
Num Trades
Spread
Number of Trades
Trade Date
7%
6%
5%
4%
3%
2%
1%
0%
45
40
35
30
25
20
15
10
5
0
Jan-14
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Oct-15
Jan-16
Apr-16
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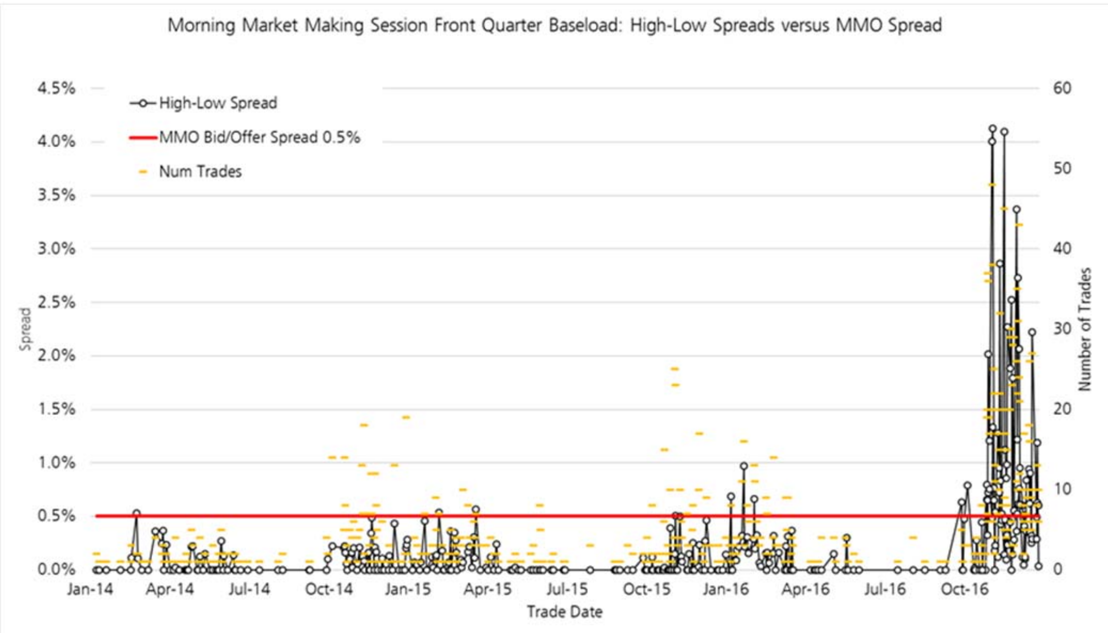
Oct-16


Morning Market Making Session Front Quarter Baseload: High-Low Spreads versus MMO Spread
High-Low Spread
MMO Bid/Offer Spread 0.5%
Num Trades
Spread
Number of Trades
Trade Date
4.5%
4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
60
50
40
30
20
10
0
Jan-14
Apr-14
Jul-14
Oct-14
Jan-15
Apr-15
Jul-15
Oct-15
Jan-16
Apr-16
Jul-16
Oct-16

We note Ofgem's comment that with the exception of Q4 2016 the volatility of power and gas prices has been following a downward trend. While the volatility in Q4 2016 can be ascribed to a particular set of circumstances, and current sentiment is that this is unlikely to be repeated this winter, this does not alter the fundamental concerns of obligated parties regarding the operation of the MMO. If the MMO is retained, it is crucial that it is capable of operating robustly in all market conditions, including any future periods of high market volatility. The evidence from Q4 2016 clearly shows this is not the case, where the binding nature of the MMO spreads meant that prices neither reflected market fundamentals nor market participants' views of risk. Consequently we do not think the MMO has met the policy objective of reliable prices through robust price discovery.

Q2. 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.

It is difficult to say to what extent the intervention has resulted in an increase in total liquidity. As illustrated at Ofgem's Secure and Promote Stakeholder workshop in May, there is no clear long-term structural trend in liquidity and the market volatility experienced in Q4 2016 was likely a significant factor in the increased volumes traded that year.

Even for those products where a more discernible trend can be seen, it is debatable whether this represents genuinely "new" volume or is (more likely) due to churn in the market making windows from obligated parties seeking to close out positions. Indeed, virtually all MMO trading is now happening between obligated parties and other large, opportunistic traders not covered by the MMO taking advantage of the restrictions faced by MMO firms (the tight spreads reduces their risk). On average the smaller suppliers the MMO is aimed at now account for less than 10% of MMO trades for EDF Trading (who manages the MMO on behalf of EDF Energy).

What is clear is the concentration of trading in the market making windows since the introduction of Secure and Promote with three-quarters of trading now taking place in the windows. This absence of liquidity outside of the windows should be of concern to Ofgem because it has affected the ability of the market to operate efficiently (including reacting to changes in fundamentals), and combined with other aspects of the MMO means traders are less willing or able to make markets naturally. It also acts as a disincentive to new trader entry as trading in the MMO windows is now riskier and operationally complex than in a feely operating market.

Q3. 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.

We agree that the near-term market remains liquid. We also agree that the increased volatility in day-ahead prices since 2015 reflects market fundamentals and the effects of cash-out reforms.

Given that near-term liquidity remains stable we believe Ofgem should consider whether the reporting requirement under Secure and Promote in respect of volumes traded in the day-ahead auction can be removed.

Q4. What are your views on our high-level analysis of the state of liquidity? Are there any factors not identified that we need to consider to assess liquidity or Secure and Promote? Please provide quantitative or qualitative evidence where relevant.

The issue is a complex one and while some of the observed effects of Secure and Promote are self-fulling due to the design of the intervention, it is difficult to attribute changes to particular factors in respect of other liquidity metrics. Tellingly, however, there is no clear long-term structural trend increase in liquidity from which robust conclusions can be drawn as to the success or otherwise of the policy.

Nevertheless, we are clear that the current inflexible design of the MMO has exposed the obligated parties to unanticipated and unacceptable levels of risk during periods of high market volatility and that urgent changes are needed to this aspect of the policy.

Q5. 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?

As indicated in our responses to Q1 and Q4 above, we do not believe the MMO works effectively during periods of high market volatility and as a result has exposed obligated parties to unanticipated and unacceptable levels of risk. This was never the policy intent.

Q6. What are your views on the fast market and volume cap rules, in particular on reducing risk for licensees when needed?

The current design of these rules do not allow obligated parties to fully and effectively manage the risks from the MMO during periods of market volatility.

In respect of the fast market (FM) rule we propose three options to enhance the effectiveness of the FM trigger. Currently the existing methodology of using a percentage change approach does not take into account the absolute price level of the mandated products. When prices are higher and a fixed percentage FM trigger is employed, obligated parties are naturally exposed to larger risks since the market would have to move more in absolute terms to reach the trigger level:

Option 1 – Hybrid FM trigger	An option is to change the FM trigger to account for absolute price levels and therefore mitigate the risk around a fixed percentage move in price i.e. keeping the exposure for each obligated party the same by having a FM that is a hybrid of percent change and the absolute price level to ensure the same amount of capital is at risk all the time, no matter what the absolute price level is. Using an example from Q4 2016 when prices were volatile, in the morning window on 1st December, Month+1 peakload (Jan 17) opened at £102/MWh and fell to £97.77/MWh triggering a FM. The value difference related to a 10MW trade between opening price and trigger price is (10MW * £102 * 0.04 * 12hrs * 31days) = £15k. However, on 15th December the same product was trading lower and opened in the morning window at £66. The value difference between the opening and trigger price if a FM is triggered at these price levels is (10MW * £66 * 0.04 * 12hrs * 31days) = £10k which is 33% lower than the 1st December. So the FM trigger needs to be set at a level where the exposure at any price level is consistent.
Option 2 – Overlapping FM trigger	Where the FM trigger is reached on one mandated product and it overlaps one or more other mandated products, this should result in a FM for all of them not just the product that has been hit. The rationale behind this is that overlapping products generally move together and so those that have not reached their FM trigger should be close to it. It then allows for obligated parties to effectively manage their exposure to multiple overlapping products particularly when they are close to physical delivery.
Option 3 – Midpoint FM trigger	The rationale for using the midpoint and not the first trade as per the current approach is to make sure the FM trigger captures those times where the bid offer spread moved up or down through the 4% level but doesn't actually trade. For example, if the opening spread was £50-£51 and then moved up to £55-£56 without trading (quite extreme but not unheard of) then under the current 'first trade' arrangements a FM would not be triggered since no trade has occurred even though the market has moved up from £50.5 (mid at open) to £55.5, a change of nearly 10% (£5/£50.5 * 100).

	However, using midpoint as the 4% FM trigger would see it triggered sooner and mitigate the risk to obligated parties as a result i.e. when the midpoint of the spread starts increasing from £50.5, the FM would be triggered after reaching a 4% in the midpoint so at £52.02 (£50.5 + £50.5*0.04) NOT £55.5. We recognise this approach may be challenging for platforms to administer.

In respect of the volume cap (VC), this should be based on the gross volume traded rather than the difference between a licensee's traded bid volume and traded offer volume. Once an obligated party has traded 30MW in absolute terms their obligation should be viewed as fulfilled in respect of that product.

Q7. What are your views on how the SMA part of the licence condition has helped smaller suppliers to access the wholesale market?

We agree the SMA has facilitated market access for smaller suppliers. We have not experienced any practical difficulties with this aspect of Secure and Promote and have not identified the need for any significant changes.

Q8. What in your view are the additional relevant external policy factors we should consider in our assessment of Secure and Promote?

Ofgem should monitor the potential impact of the EMR Feed in Tariff Contracts for Differences (CfD) on liquidity, recognising that CfD holders will be naturally incentivised to trade in the CfD reference price markets to minimise the basis risk between CfD difference payments and power market revenues.

More broadly, the "re-opener" provisions of the MMO should be widened so that a MMO licensee can request a review of the MMO in the event of any material/structural change in the wholesale market. This would include any further reduction in the number of MMO obligated parties and market changes stemming directly from, or as a reaction too, the political or policy arena. In such circumstances the MMO should be immediately suspended to allow an assessment of the impact of the change on the MMO and feasibility going forward.

Q9. What are your views on amending the licence condition to allow flexibility during certain market conditions?

We agree the licence condition needs to be more flexible to allow the obligated parties to better manage the risks from their MMO activities during periods of volatility. We note Ofgem's suggestion that having the ability to adjust the obligations without licence change would better allow the obligations to adjust to changing market conditions.

However, we would prefer to see the MMO designed so that it is sufficiently flexible from the outset to work effectively in all market conditions, thus avoiding the need to react on an ad-hoc basis as market conditions change. Specifically, we believe the following changes are required to the MMO:

Extend the market making windows
As indicated in our response to Q2 the MMO has resulted in liquidity being concentrated into the morning and afternoon market making windows with very little activity outside of these. We think this is a problem and believe longer MMO windows will provide greater flexibility (meaning market participants will be more willing to trade in the window/market for longer), and help to encourage new entry.

However, any extension of the windows must be accompanied by a relaxation of the MMO spreads and revised FM and VC rules.

Relaxation of bid-offer spread
A relaxation of the current mandated spreads is needed to enable obligated parties to better manage the risks from their market making activities, particularly during periods of market volatility. We have previously suggested to Ofgem that the existing spreads should operate as soft-caps with the ability to move away from them if justified by circumstances. Any exceedances of the "soft cap" would be highlighted by obligated parties as part of their usual reporting, with further information and justification available on request. This could be supplemented by a volatility index published by Ofgem which could be used to compare spreads during volatile periods as part of obligated parties MMO reporting.

This approach would allow MMO obligated parties to maintain the current high levels of service during normal market conditions within the current mandated spreads, but crucially allow them to revert to market reflective bid/offer spreads during periods of higher volatility.

Changes to the FM and VC rules
As indicated in our response to Q6, we believe changes to the fast market and volume cap rules are needed.

Remove the MMO during days approaching delivery
Within this horizon, supplier positions are driven by weather forecasts and therefore shorter-term products are more appropriate than the longer-term hedging products covered by the MMO. Additionally, there have been situations where it has become extremely difficult for obligated parties to balance a physical position on a MMO product in the last trading window before delivery of the product begins.

This creates a risk to obligated parties of being stranded with an unbalanced position going into physical delivery. Removing the MMO on the last two trading days before a product enters physical delivery will allow obligated parties to manage properly any physical positons arising from their MMO obligation before the start of delivery of these products.

Qualifying platform
Ofgem should review the criteria for qualifying platforms. In particular, Ofgem should ensure the platform used by an obligated party to fulfil its market making obligation is liquid in respect of the mandated products.

We recognise that requirement 5(d) of Schedule B of the licence condition requires an obligated party to have a reasonable expectation that the relevant products will be traded on the platform, but we would question whether this goes far enough. For example, we are aware that one obligated party has chosen to post its MMO activity on the ICE platform where there is little liquidity. Consequently, Ofgem should consider strengthening the criteria for what constitutes a qualifying platform.

We appreciate Ofgem cannot be seen to be promoting one platform over another, but equally it should be satisfied that MMO activity is carried out on platforms where there is actual trading in the mandated products. This concern reduces if the MMO is applied to a bigger number of market participants (see response to Q11).

From the above we see a relaxation of the mandated MMO spreads as the most important change Ofgem should make. Indeed, it is possible that the other changes suggested above become less important (and would make the MMO less complicated) if the MMO spreads provide sufficient flexibility so that obligated parties can carry out their market making activities in a way which properly reflects market fundamentals and their views of risk.

Therefore as a minimum, Ofgem should consider a relaxation of the MMO spreads for a trial period. Not only would this allow obligated parties to manage their risks efficiently and restore confidence in the price discovery mechanism, it would also provide Ofgem with a better picture of how spreads react to different market conditions.

Q10. 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.

In addition to the cost of resourcing Secure and Promote there is a cost to obligated parties from managing the risks of their market making activities. We have highlighted above our concerns regarding the unintended and unacceptable levels of risk arising from this during periods of high market volatility under the current MMO.

The cost to EDF Energy of this was shared with Ofgem in our letter to Cathryn Scott of 27 January 2017. From our perspective the MMO has introduced demonstrable levels of risk to obligated parties against largely unproven benefits.

Q11. 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 indicated in our response to Q9 we believe the MMO is in need of urgent reform to reduce the risk to obligated parties and to ensure it can work effectively in all market conditions.

There is a further important aspect not discussed in the consultation in respect of the scope of the MMO in terms of obligated parties.

Ofgem's original criteria for the choice of obligated parties included (a) whether the entity had a large and stable market share of the domestic supply market, (b) whether they were vertically integrated (having a significant presence in both generation and supply, (c) whether they had trading capabilities and (d) whether the licensees chosen would be effective in delivering the market making policy.

We believe it is appropriate for Ofgem to keep both the criteria used and the resulting choices made under review, in particular to avoid unfairly discriminating between licensees as circumstances change.

We believe there have been important and relevant changes since Ofgem's 2013 MMO decision that should now be taken into account:

- In its 2016 investigation, the CMA found *"that vertical integration does not appear to have a significant impact on liquidity"* and noted *"that while in theory the natural hedge could reduce the amount of trading vertically integrated firms undertake on the wholesale market, given the relatively limited scope for the natural hedge, any impact is unlikely to be significant in practice."* Ofgem's use of Vertical Integration (and its focus on only including use of domestic supply market shares) is therefore no longer appropriate in light of the CMA's findings
- E.ON/Uniper is no longer being an obligated party, and with a further obligated party posting its MMO activity on the ICE platform where there is little liquidity, the reality is that there are now only four obligated parties posting prices in the actively traded market. This means the number of obligated parties is now exceeded by the number of large unobligated parties with the result that market risk is concentrated on the remaining obligated parties. Ofgem should consider whether these currently unobligated parties fulfil Ofgem's criteria above (having excluded the VI related criteria as no longer appropriate), i.e. whether they have trading capabilities and could effectively deliver the MMO

Taking account of these changes, we believe the MMO should apply to any party (generator or supplier) meeting the following revised criteria:

(a) whether the entity is sufficiently large (has a large and stable market share of the supply market or is a generator with an installed capacity of 1.5GW or above)

(b) whether they have trading capabilities (which we expect all large players to have) and
(c) whether the licensees chosen will be effective in delivering the market making policy.

If any existing MMO party is relieved of its licence obligations or any other party is brought into scope of the MMO there should be an immediate suspension of the MMO while Ofgem assesses the impact on the (remaining) obligated parties and the parameters of the MMO. When Uniper/E.ON was removed from the MMO there was no pause in the operation of the obligation or consultation by Ofgem on its potential impact. This is not acceptable.

We note Ofgem's comments that many independent suppliers have requested greater liquidity in forward 'block' products that are more granular than peak and baseload products. Ofgem should not assume that obligated parties naturally trade such shaped products. Therefore, careful consideration would need to be given to any decision to add to the list of mandated products.

Q12. Is there any other relevant stakeholder feedback we haven't captured that we should consider?

We would urge Ofgem to consider the approaches taken in other energy markets to improve liquidity. For example, we are aware New Zealand has introduced market making arrangements more focused on commercial incentives. Ofgem will recall EDF Energy proposed a commercially based MMO at the time the Secure and Promote Licence Condition was being developed and believe Ofgem should consider revisiting the MMO on this basis. We see our recommendations, particularly on relaxation of spreads, as supporting such an approach.

EDF Energy
September 2017