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Dear colleague,

**Request for modification of Special Condition AA of Electricity Generation Licences held by the ScottishPower corporate group**

On 21 December 2018, ScottishPower formally requested that Ofgem[1] remove Special Condition AA: Liquidity in the Wholesale Electricity Market from Electricity Generation Licences held by companies within the corporate group. Scottish Power is currently subject to Schedules A, B and C of this licence condition.

ScottishPower's main argument in support of their request relates to changes in the group's strategy. Structural changes have led them to sell some of their generation assets, thereby reducing their market share compared to 2014 when Special Condition AA was first introduced into the licences of companies in their group. ScottishPower make the case that, as a result of changes in their generation market share, they should no longer be subject to the licence condition.

We have assessed ScottishPower's request against our rationale for applying the licence condition originally and the non-exhaustive factors outlined in our guidance document on the condition. This letter sets out the background to the request and explains our reasons for consenting to it. To give effect to the changes, pursuant to Paragraph AA.1 of the Special Condition, today we have published a direction addressing the Electricity Generation Licensees in the ScottishPower corporate group[2]. We have considered our statutory duties and in particular our principal objective to protect the interests of existing and future electricity and gas consumers in making this decision.

## Background

Special Condition AA: Liquidity in the Wholesale Electricity Market ('the Secure and Promote licence condition') first became effective on 31 March 2014. Liquidity is an important feature of a well-functioning market for a number of reasons. Liquid wholesale energy markets give market participants the confidence that they can buy and sell at prices that reflect underlying demand and supply conditions. They allow firms to manage risk effectively and reduce the scope for market manipulation. Importantly, they also provide transparent prices on which non-vertically integrated generation and supply

[1] References to the "Authority", "Ofgem", "we", and "our" are used interchangeable in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day-to-day work. This decision is made by or on behalf of GEMA.
[2] "ScottishPower" and the "ScottishPower corporate group" refer to companies with the immediate holding company Scottish Power UK plc within this document.

businesses can base their investment decisions, and potential entrants can assess opportunities to enter the market.

The Secure and Promote licence condition aims to improve liquidity in three ways:

- **Schedule A - Supplier Market Access Rules**: seeks to improve the availability of products that support hedging, by requiring the eight largest electricity generating companies to follow a set of rules when trading with small independent suppliers. These include defined standards for dealing with requests for trading agreements, pricing, products and minimum clip-sizes.
- **Schedule B - Market Making Obligation**: seeks to ensure the availability of robust reference prices for wholesale electricity products along the forward curve. Four large vertically integrated generation and domestic supply companies[3] are required to simultaneously post bids (buy) and offers (sell) orders for specified forward wholesale electricity products on energy trading platforms throughout two daily trading windows.
- **Schedule C - Reporting Requirements**: monitors forward and near-term market liquidity by imposing reporting requirements on obligated licensees.

**Assessment criteria**

We have assessed ScottishPower's request by considering our June 2013 Final Proposals document on wholesale electricity market liquidity[4] in which we set out our rationale for applying the condition; and our 2014 Guidance on the condition[5], which sets out the non-exhaustive factors that we take into account when considering whether to remove the licence obligations or add them in the generation licences of companies in additional corporate groups.

*Criteria for Schedule A - Supplier Market Access Rules*

Our Final Proposals document indicates the main purpose of the Supplier Market Access rules is to ensure that suppliers can get access to power in the wholesale market and that the firms in the market that are best placed to provide this power are the larger generators. It is for this reason that we proposed that the eight largest GB electricity market generators should face the rules.

Paragraph 1.10 of the Guidance contains the non-exhaustive factors that we will use in combination as the basis of any decision on whether to remove or add Schedules A, B or C of the licence condition to the generation licences of any corporate group. These factors are:

i. **Changes to generation market share:** any significant and sustained changes in the generation market share or generation output of a corporate group, taking into account its relative market share and overall size.

ii. **Disproportionate risks or costs:** an indication that an existing Secure and Promote licensee will face disproportionate costs and risks in continuing to meet the licence condition, or that a potential new Secure and Promote licensee could meet the costs and risks proportionately.

[3] These are SSE , ScottishPower, EDF Energy and RWE. Schedule B was originally included in the generation licences held by the E.ON corporate group but it was removed in November 2016 following E.ON's divestment of Uniper. Schedule B was originally included in generation licences held by the Centrica corporate group but was removed in August 2018 following significant and sustained changes in their generation market share.
[4] Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition https://www.ofgem.gov.uk/sites/default/files/docs/2013/06/liquidity-final-proposals-120613_0.pdf
[5] Liquidity in the Wholesale Electricity Market (Special Condition AA of the electricity generation licence): Guidance. https://www.ofgem.gov.uk/ofgem-publications/86717/liquidityinthewholesaleelectricitymarketspecialconditionaaoftheelectricitygenerationlicence-guidance-pdf

iii. **Success of the licence condition:** the sustained successful achievement of the objectives of this licence condition.

*Criteria for Schedule B – Market Making Obligation*

In our Final Proposals document we set out our rationale for applying the Market Making Obligation to six vertically integrated electricity generation and supply businesses as follows:

- **The domestic supply market –** at the time, the firms we proposed to subject to the market making obligation, controlled around 98 per cent of the domestic supply market, and held broadly stable shares of this market. In our view this market structure may have been reducing suppliers' incentives to trade in the wholesale market.

- **Vertical Integration** - the firms we proposed to subject to the obligation had a substantial presence in both generation and domestic supply markets. Vertical integration provides an alternative to wholesale market trading that is not available to independent players. While the proposed licensees did participate in the wholesale market, we considered they had an ongoing option to source energy from their affiliate business as an alternative.

- **Trading capabilities –** because of their size and vertical integration, the firms we proposed to subject to the obligation regularly took both long and short positions and had the capabilities to take a sophisticated view of market prices. In our view this meant that the costs they were likely to face in meeting the obligation would be small in comparison to their existing businesses.

- **Effectiveness of the intervention –** we considered the market making intervention could be delivered successfully with the licensees we had identified. The benefit of additional market makers might be limited, but the costs would be higher. We considered our proposed list of licensees provided the best balance of costs and benefits to consumers.

The three factors from our Guidance listed in the section above as relevant to the consideration of the removal of Schedule A are also relevant to the consideration of Schedule B. In addition, the Guidance lists a fourth factor applicable exclusively to Schedule B:

iv. **Changes to supply market share:** 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 overall size.

**Supporting evidence and our assessment**

The following paragraphs contain ScottishPower's evidence to justify the removal of the Secure and Promote licence condition from the Electricity Generation Licences held by companies within the group and our assessment of ScottishPower's request, in accordance with the assessment criteria listed above.

*Assessment for Schedule A – Supplier Market Access Rules*

ScottishPower explain that following the sale of ScottishPower Generation Limited to Drax in December 2018, 2,566MW of their generation capacity has been divested. ScottishPower highlight that after analysing data published by the Department of Business, Energy and Industrial Strategy in 2018 on the electricity generation capacity installed in Great Britain, their market share was 4.4% before the sale to Drax and is now 1.9%. ScottishPower believe that this represents a significant and sustained reduction of their generation market share. ScottishPower also state that as their remaining generation capacity comprises of wind powered generation stations, they would not have the ability to schedule generation output to reflect normal wholesale market price signals.

When the Secure and Promote licence condition was introduced in March 2014, Ofgem used generated metered volume data to assess ScottishPower's market share as approximately 6% of the market.[6] Our latest assessment using this data shows that ScottishPower had a market share of 3.9% at the end of 2017[7], and this share would have been 1.2% if the generation assets they have since divested were excluded[8]. While the use of different data sets produces different valuations of ScottishPower's current market share, both imply a notable decrease following the sale.

Our rationale for requiring parties to comply with the Supplier Market Access rules was based on a substantial presence in the generation market. We agree with ScottishPower's assessment of their significant and sustained reduction in generation market share and note that they are no longer one of the largest eight generators in the market. We further consider that, as a consequence of this reduction and their lack of schedulable generation capacity, ScottishPower would face disproportionate costs and risks in complying with the Supplier Market Access rules. This view is consistent with our assessment of E.ON SE corporate group's request for removal of their equivalent obligations[9].

We think that the Secure and Promote licence condition is yet to fully meet its objectives[10]. We do not have any evidence to suggest that the balance of costs and benefits to consumers of the Supplier Market Access rules would change significantly if ScottishPower no longer complied with them. Our overall assessment is that, for the reasons above, we consider it would no longer be appropriate for the companies in the ScottishPower corporate group to face the Supplier Market Access rules.

*Assessment for Schedule B – Market Making Obligation*

ScottishPower note that they are experiencing a continuing loss of domestic supply market share since 2006, as demonstrated by Ofgem's retail market indicators. ScottishPower explain that due to the reduction in their generation market share and their lack of schedulable generation capacity, they would no longer be capable of meeting a significant proportion of the electricity demand from their domestic supply business. Therefore, any disincentive for companies in the corporate group to trade in the wholesale market would be significantly reduced.

ScottishPower state that they have been exposed to significant cost and credit risk of meeting the Market Making Obligation in 2017, and note that the release of E.ON and Centrica from the obligation leaves four remaining obligated parties to handle the trading volumes previously undertaken by these companies. They further highlight that due to their lack of schedulable generation, they will now face higher costs and risks from the Market Making Obligation, and will also face credit risk costs which would be disproportionate to their smaller position in the generation market.

According to our data, ScottishPower's domestic electricity supply market share was 10% as of Q2 2018, compared with 12% in Q1 2013, placing it as the fourth largest domestic electricity supplier. On its own, we do not believe this constitutes a significant and

[6] Based on metered generation volume and interconnector imports. Generation shares are based on proprietary data. Station demand has been excluded. Please see 2015 Great Britain and Northern Ireland National Reports to the European Commission for more details: https://www.ceer.eu/documents/104400/3737359/C15_NR_GB-EN.pdf/ca0390a9-b6a2-bd9b-cb33-d17e65428e56
[7] https://www.ofgem.gov.uk/data-portal/wholesale-market-indicators
[8] These calculations exclude the Galloway and Lanark hydro assets (126MW) and the Blackburn CCGT asset (60MW).
[9] https://www.ofgem.gov.uk/system/files/docs/2016/11/e.on_uk_special_condition_aa_letter.pdf
[10] The reasons for our views are explained in our 2018 decision on Centrica's request for modification of Special Condition AA of the Electricity Generation Licences held by the Centrica company group and remain valid: https://www.ofgem.gov.uk/system/files/docs/2018/08/centrica_special_condition_aa_decision_letter.pdf

sustained change in supply market share that would justify removal of ScottishPower's Market Making Obligation. However, a basis for Ofgem subjecting parties to the Market Making Obligation is a substantial presence in both the generation and domestic supply markets. As ScottishPower has reduced its generation market share, we consider it no longer has a sufficiently significant presence in electricity generation and note that we have not proposed to obligate additional licensees without a significant electricity generation market share to undertake market-making activities. Furthermore, the extent of ScottishPower's vertical integration has also decreased and it no longer has schedulable generation capacity capable of meeting a significant proportion of the electricity demand from its domestic supply business, and we consider it has no advantage over any other non-vertically integrated parties in the market.

We recognise that a reduction in the number of obligated parties under the Market Making Obligation is likely to have increased the costs of compliance for the remaining obligated parties. However, we do not have evidence to suggest that ScottishPower's costs of complying with the Market Making Obligation have exceeded Ofgem's initial cost forecast[11] and have been disproportionate. We recognise, however, that the changes to ScottishPower's structure may increase the costs relative to a more vertically integrated corporate group (i.e. buying electricity to meet the obligation).

As above, we think that the Secure and Promote licence condition is yet to fully meet its objectives. Without ScottishPower, there would be three remaining parties with the Market Making Obligation. The robustness of the reference prices available and the overall effectiveness of the intervention may fall with a smaller number of market-makers. However, at this stage we do not have clear evidence to suggest that three obligated parties will be significantly less effective than four. We will continue to monitor and assess the effectiveness of the Market Making Obligation and the costs and risks to obligated parties in light of market developments. Alongside this, we will investigate potential options and alternatives to the Market Making Obligation to support liquidity.

Our overall assessment is that based on our current rationale for obligating parties, it would no longer be appropriate for the generation companies in the ScottishPower corporate group to face the Market Making Obligation based on their reduced generation market share and vertical integration. This view is consistent with our assessment of similar requests from the E.ON and Centrica corporate groups to remove their respective Market Making Obligations.

*Assessment for Schedule C - Reporting Requirements*

Given our assessments of Schedule A and Schedule B of the Secure and Promote licence condition above, we see no reason for the Schedule C obligations to apply.

## Our decision

For the reasons outlined in this letter, we consent to ScottishPower's request to have Special Condition AA: Liquidity in the Wholesale Electricity Market removed from the Electricity Generation Licences held by the corporate group. To give effect to this decision, we have today published a direction disapplying the licence condition in its entirety in the relevant Electricity Generation Licences.

Yours faithfully

**Chris Thackeray,**
**Head of GB Wholesale Markets**

[11] At the time of our original impact assessment, we estimated that the ongoing costs of complying with Market Making Obligation would be around £2.4m per licensee per year.