

To all stakeholders

Email:

wholesalemarketoperation@ofgem.gov.uk

Date: 14 November 2019

Dear colleagues,

Decision to suspend the Secure and Promote Market Making Obligation with effect on 18 November 2019

On 08 October 2019, we published an open letter seeking views on our 'minded to' position to suspend Schedule B of Special Condition AA of the Generation Licence (the Market Making Obligation, "MMO") in the event that we released RWE Generation plc ("RWE") from the Licence Condition¹. In the letter, we cited concerns that that the policy could become less effective in meeting its objectives and that the remaining parties could be subject to disproportionate and potentially unfair costs.

The letter noted that on 19 September 2019, Ofgem² received a request from RWE for the MMO to no longer have effect in their Generation Licence on account of changes to the company's structure following the sale of their shareholding in Innogy SE to E.ON on 18 September 2019. Following an assessment of the evidence provided by RWE, on 29 October 2019 we published our decision to consent to the request, with this decision taking effect on 30 October 2019³.

In light of this decision, and having now considered all responses to the open letter including some which provided evidence on the cost implications of a two-party MMO and stakeholder feedback on the likely impact of suspension, we have decided to suspend the MMO immediately for the following reasons:

¹ https://www.ofgem.gov.uk/system/files/docs/2019/10/ofgem.secure_promote_open_letter_october_2019_ct.pdf

² References to the "Authority", "Ofgem", "we", and "our" are used interchangeably 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.

³ <https://www.ofgem.gov.uk/publications-and-updates/request-schedule-b-special-condition-aa-no-longer-have-effect-rwe-generation-plc-s-electricity-generation-licence>

- Cost evidence that indicates the move to a two-party MMO has materially increased the costs incurred by the remaining parties, even in the absence of market volatility; and,
- Mandating only two parties under the current obligation places disproportionate costs on these parties; and,
- Evidence that indicates the policy has become less effective in meeting its objectives, specifically in enabling the development of robust reference prices along the curve.

To give effect to this decision, pursuant to Paragraph AA.1 of the Special Condition, we have today issued a Direction to the relevant Electricity Generation Licences holders who are affiliates of EDF Energy Limited and SSE PLC⁴. This Direction will take effect on Monday 18 November 2019. 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.

Summary of stakeholder responses

We received 16 responses to our open letter, predominantly from generators, suppliers and energy traders, with 11 providing an explicit position on suspension. All non-confidential responses to the open letter have been published online.

1) Views supporting suspension

Six respondents supported suspension, with five arguing that the MMO be immediately suspended. These respondents included the original obligated parties.

The key arguments made across these responses concerned:

⁴ https://www.ofgem.gov.uk/system/files/docs/2019/11/mmo_suspension_direction.pdf Standard Generation Licence Condition 1 – ‘Definitions and Interpretation’, Paragraph 1 – “affiliate” “in relation to any person means any holding company of such person, any subsidiary of such person or any subsidiary of a holding company of such person, in each case within the meaning of sections 1159 and 1160 of the Companies Act 2006”. Section 1159 (1) of the Companies Act 2006 states that “A company is a “subsidiary” of another company, its “holding company”, if that other company—
(a) holds a majority of the voting rights in it, or
(b) is a member of it and has the right to appoint or remove a majority of its board of directors, or
(c) is a member of it and controls.

(i) The costs of the obligation becoming unfair and disproportionate

Five respondents argued that the continuation of the current MMO would be unfair as it would subject the two remaining parties to disproportionate costs and credit risks previously shared across six parties. The two remaining obligated parties provided confidential cost evidence to argue that, as a consequence of moving to a two-party MMO, there has been a material increase in the costs and market risk of the obligation, even in the absence of volatility, with their ability to effectively manage this risk constrained by a lack of market depth.

(ii) An erosion in the effectiveness of the MMO

Three parties argued that the effectiveness of the current MMO has been undermined by the reduction in the number of mandated market-makers. Respondents noted that volumes available under the obligation were now one-third of those originally envisaged which, in conjunction with a lack of market depth, would limit the opportunities for natural price discovery and robust prices. The two obligated parties also provided evidence to argue that trading patterns, resulting as a consequence of the removal of RWE, are affecting the sustainability and integrity of the market-making windows.

(iii) The likely impacts and risks of suspension for the market

Four respondents argued that there was no evidence that suspension of the MMO will have a significant negative impact on liquidity, with one arguing that the obligation has had a distortive impact on competition and natural patterns of liquidity. These respondents argued that suspension was unlikely to have a significant adverse impact on the market on account of significant market changes since the inception of the MMO in 2014. Factors cited in support of this argument included: a reduction in vertical integration and the entry of smaller generation and supply companies increasing the number of parties trading in the market; that the original MMO parties will remain as active participants and continue to provide liquidity for a range of power products, including longer term products; and that removal of the MMO windows will allow trades to occur in a more natural pattern throughout the day, allowing traders to react in real-time to events happening in the markets.

- (iv) The benefit of suspension in assessing the need for intervention

Four respondents argued that suspension would ensure a more robust assessment of whether intervention to support liquidity is still required.

2) Views against suspension

Five responses, including one from a group of nine independent generators and suppliers, were against suspending the MMO. These responses were predominantly from independent generators and suppliers and energy traders.

The key arguments made across these responses concerned:

- (i) The likely impact and risks of suspension for the market

All five responses that provided a clear view against suspension argued that removal of the MMO would result in a material deterioration in liquidity. Concern for the impact of suspension on liquidity was also present in the five responses providing a neutral or more ambiguous position on suspension. These respondents typically anticipated that suspension would result in wider bid-ask spreads and a reduction in traded volumes and available products, which would negatively impact the ability of suppliers and generators to hedge effectively. Three responses argued that wholesale costs would increase, which would lead to higher costs for consumers. This was identified as a risk for market participants trading directly in the market and those working through third-parties. Two respondents also argued that suspension would result in the removal of the price transparency provided by the market-making windows, which is used to inform bilateral trades and efficiently fix Power Purchase Agreements.

- (ii) Disproportionate impact on small suppliers

Four respondents argued that suspension of the MMO would have a disproportionate impact on small suppliers who would be less able to mitigate rising costs through reviewing their purchasing strategies or creating other cost efficiencies. These responses argued that by making it harder and more expensive for independent generators and suppliers to buy and sell power, there would be a negative impact on competition in the GB wholesale market. Two respondents made reference to the series of retail supply company failures over the

past two years, arguing that removing a mechanism that increases liquidity will put further pressure on the remaining small players.

- (iii) The MMO should be replaced not suspended

Respondents opposed to suspension typically acknowledged that the current design of the MMO has become obsolete but argued that an alternative liquidity support measure should be implemented instead of suspension and urged Ofgem to prioritise ongoing investigations into potential alternatives.

Reasons for our decision

In making this decision, we have balanced evidence provided on the costs and limitations of the two-party MMO against what we can reasonably assume to be the likely impact of suspension. Our 06 October 2019 open letter made reference to the announcement from SSE on 13 September 2019 that it had entered into agreement to sell its retail services business to OVO Energy Limited, and reiterated our November 2018 position that we do not think the MMO, as currently designed, could continue with one party. While we remain of this view, evidence provided in response to the open letter indicates that this position also applies, albeit to a lesser extent, to the operation of a two-party MMO.

Costs and limitations of the two-party MMO

- (i) Confidential cost evidence provided by the two remaining obligated parties indicates that, following the release of RWE, the costs and market risk faced by the remaining parties have materially increased, even in the absence of volatility. Evidence indicates that the reduction in market depth has limited the ability of the two parties to execute risk mitigation strategies which have traditionally allowed them to avoid unbearable costs. There is, therefore, a strong likelihood that the costs of the obligation will increase beyond those identified in Ofgem's 2013 Secure and Promote Impact Assessment⁵.

⁵ https://www.ofgem.gov.uk/sites/default/files/docs/2013/11/impact_assessment_-_wholesale_power_market_liquidity_-_statutory_consultation_on_the_secure_and_promote_licence_condition.pdf

- (ii) Mandating only two parties under the current obligation places disproportionate costs on these parties. In 2014, the obligation was placed on six companies with a combined retail market share of 94% and a 70% share of the generation market⁶. This had the effect of spreading the costs and risk of the policy across the market, reducing the risk of any associated competitive disadvantage between the larger market players of the time.⁷ As of 30 October 2019, the retail and generation market shares of the two remaining parties are 24%⁸ and 36%⁹.
- (iii) Confidential evidence on trading patterns indicates that the policy has become less effective in meeting its objectives, specifically in enabling the development of robust reference prices along the curve. This substantiates our concern that lower volumes and a lack of market depth would undermine the opportunities for natural price discovery and price robustness. Several respondents to the open letter noted that reference prices will still be available through Price Reporting Agencies (PRAs). PRAs will continue to report estimated prices of forward trades on a daily basis and brokers and exchanges will continue to operate market places with live trade orders.

Potential impact of suspension on the market

As noted in our open letter, the influence of the MMO on the market means we cannot know with any certainty what the impact of suspension will be, with responses to the letter providing contradictory and often unsubstantiated views. We do, however, anticipate that the removal of mandated bid-ask spreads for the MMO products will lead to wider spreads as posted prices move to reflect market conditions. While the extent to which spreads will widen is uncertain, we have seen no justified evidence that there will be a widening of spreads sufficient enough to outweigh the costs, risks and unfairness of continuing with the two-party MMO. For example, while some respondents suggested that spreads could return to pre-MMO levels, this was countered by several respondents who argued that the impact of suspension on liquidity will be muted or positively influenced by fundamental market

⁶ <https://www.ofgem.gov.uk/data-portal/electricity-supply-market-shares-company-domestic-gb>

⁷ Our 2013 Final Decision document explained the factors we had considered when determining who would face the MMO. This included consideration of: the structure of the generation and supply markets; the key players in the market; licensees' capability to meet the obligations at proportionate cost and risk; and the need to ensure that the intervention is effective. <https://www.ofgem.gov.uk/ofgem-publications/39302/liquidity-final-proposals-120613pdf>

⁸ <https://www.ofgem.gov.uk/data-portal/electricity-supply-market-shares-company-domestic-gb>

⁹ https://www.ofgem.gov.uk/data-portal/all-charts?search_api_views_fulltext=market+share and https://www.ofgem.gov.uk/system/files/docs/2019/10/20191030_state_of_energy_market_revised.pdf

changes that have altered market structure and increased the depth of market participation over the last five years.

Nonetheless, we acknowledge that the likely cost impact of wider spreads is an increase in transaction costs and a potential negative impact on price robustness, which could impact suppliers' and generators' ability to hedge. The extent of this cost impact is uncertain and it will not necessarily rise in line with wider spreads. Moreover, we have not seen clear evidence that wider spreads will result in higher wholesale prices as while price discovery may become impaired, prices will continue to reflect fundamental market drivers.

We also do not expect market access structures to change significantly as a result of suspending the MMO. As we do not intend to remove the Supplier Market Access Rules, small suppliers will still be able to trade bilaterally with parties' subject to Schedule A of the Secure and Promote Licence Condition and we expect third-party intermediaries to continue to compete when providing small suppliers with a route to market.

Next steps

To give effect to this decision, we have today issued a Direction to the relevant Electricity Generation Licences holders who are subsidiaries of SSE and EDF. We consider that the market was given notice of this potential direction of travel in our November 2018 update¹⁰, which highlighted that market participants should prepare for the suspension of the MMO if the number of obligated parties reduced further. Since this time, two parties have been released from the MMO.¹¹ On account of this, and evidence on the cost-risks already being experienced by the two remaining parties, this decision will take effect on Monday 18 November 2019.

During the suspension, we will continue to monitor market liquidity with a view to assessing the impact of suspension on liquidity and the need for intervention. We will shortly issue a Request for Information to market participants that will gather data to monitor how liquidity changes throughout the trading day. We will continue to consider and develop

¹⁰ <https://www.ofgem.gov.uk/publications-and-updates/november-2018-update-secure-and-promote>

¹¹ Schedules A, B and C ceased to have effect in the Generation Licences held by the ScottishPower group in January 2019 following changes in the group's strategy and Schedule B ceased to have effect in RWE's Generation Licence from 30 October 2019. <https://www.ofgem.gov.uk/publications-and-updates/request-modification-special-condition-aa-scottishpower-s-electricity-generation-licences> and <https://www.ofgem.gov.uk/publications-and-updates/request-schedule-b-special-condition-aa-no-longer-have-effect-rwe-generation-plc-s-electricity-generation-licence>

alternatives to the current MMO as part of our on-going Options Assessment and, in the event we consider intervention is still required to support liquidity, we will consult on our preferred approach. Market participants should be aware that there are no immediate fixes that could be put in place to support liquidity. It would take a minimum of six months before alternative policy could be implemented.

We welcome continued stakeholder engagement as we assess the impact of suspension on liquidity and develop longer-term alternatives to the MMO. To discuss further, please contact: Heather.Stewart@ofgem.gov.uk.

Yours sincerely,

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