

Energy UK - Secure and Promote Position Paper

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Introduction

Ofgem has previously informed Energy UK members that its intention was to review the entirety of Secure and Promote (S&P), starting in 2019; and that a potential solution to replace the current obligations could be established before winter 2019. Ofgem's subsequent Open Letters of August and November 2018 questioned the effectiveness of the market making obligation (MMO) policy in light of the recent exemptions and suggested that the MMO, as currently designed, may not be sustainable going forward.

In January 2019, Energy UK organised a workshop for members to discuss and seek alignment on the preferred way forward in relation to GB wholesale market liquidity. This note provides a summary of the workshop conclusions.

This note sets out Energy UK's views on the factors that Ofgem should consider as part of the review specifically focusing on the MMO given that the other elements of S&P are working sufficiently. The factors that Ofgem should consider are (a) the criteria that should be used to evaluate alternatives to the MMO; and (b) those policy options that Ofgem should explore in more detail as the most promising options to replace the MMO.

Energy UK summary views

Energy UK members agree that the MMO provision within the S&P policy must be reviewed. We support Ofgem seeking additional resource in order to progress this work. As noted by Ofgem in its August 2018 open letter, the design of the current MMO needs to be reviewed in the light of changes to industry structure. Energy UK therefore requests Ofgem to launch a review of the MMO to support an informed and evidence-based decision.

- When evaluating the future of the MMO, Ofgem must consider the effects that the intervention has had on the market over recent years, particularly with regard to the level of liquidity and level of market-entry by new players.
- Energy UK members note Ofgem's views stated in the August 2018 open letter that the MMO, as currently designed, may not be robust to changing market conditions and business structures and that this may lead to its suspension. However, Energy UK members' views in relation to the suspension of the MMO or interim changes in relation to this intervention differ.
- Energy UK members recognise that Ofgem's review of the MMO and any alternatives will be assessed against a counterfactual of there being no regulatory mechanism supporting wholesale market liquidity.
- Energy UK members agree that an enduring MMO solution, where such intervention is found to be required by Ofgem, should meet a set of criteria, as outlined further in this note.
- Energy UK members agree that certain enduring MMO options are more preferable to others. These options are outlined further in the document.

Evaluation Criteria

Energy UK proposes that Ofgem should take into account the following principles when considering an enduring MMO solution, if an intervention was found to be necessary:

- **Liquidity.** Any intervention should improve GB wholesale market liquidity;
- **Fairness.** Any intervention should support fair access to liquidity for all market participants, and should distribute the costs of meeting the obligation fairly.
- **Cost effectiveness.** The cost of meeting any obligation should be proportionate to the impact on liquidity.
- **Transparency.** The cost and benefits of any intervention should be transparent to Ofgem and market participants.
- **Future proof.** Any intervention should be robust to structural change in the industry and should be capable of being phased out as GB power market liquidity improves.
- **Evidence-based conclusion.** The design parameters should be justified by evidence of their net benefit to wholesale market liquidity.

Enduring intervention design options (where intervention deemed necessary)

Energy UK notes that Ofgem has discussed a number of high-level design options as the basis for a regulatory intervention to support liquidity. These options included:

- No change,
- Remove the MMO,
- Amend the MMO,
- Tendered market maker,
- Mandatory auctions, and
- Self-supply restriction.

As noted earlier, Energy UK members recognise that Ofgem's review will consider the MMO suspension as a counterfactual to any MMO alternatives. Where a regulatory intervention is deemed necessary on an enduring basis, Energy UK members view on enduring intervention options are as follows:

Option 1: Amend the MMO

Energy UK members share the view that, if an MMO is deemed necessary, it should be designed in such a way so that it meets the criteria set out above. Specifically, Energy UK members agree that Ofgem should consider the following details when amending the MMO:

1. **Basis for the obligation.** The basis for imposing the obligation on any market participant should be stable and robust to changes in the industry or company structure.
2. **Cost allocation.** The costs imposed on any market participant as a result of the obligation must be fairly distributed across the industry in a transparent way.
3. **Impact on GB liquidity.** The market making obligation should achieve a proportionate balance between the costs imposed and improvement to market liquidity through the calibration of the following design parameters:
 - a. length and frequency of any market making window
 - b. identification of products
 - c. setting any mandated spreads
 - d. the percentage of time that parties are required to post prices
 - e. measures to mitigate costs of market making, such as volume caps, fast market rules or soft-landing windows etc.

While these design parameters are listed separately, it is important to recognise that they are closely linked. The more stringent the parameters are, the more challenging the process for imposing the obligation and achieving a fair allocation of costs becomes.

Option 2: Tendered Market Maker (preferred option)

Energy UK considers that Ofgem should investigate the option of replacing the MMO by tendering for market makers. Requiring a party (such as National Grid Electricity System Operator) to tender for market makers may provide a more straightforward route to meet the evaluation criteria outlined in Section 3. Specifically, a tendered MMO helps to provide a fair (voluntary) basis for identifying the obligated parties, ensures greater transparency on the costs and benefits of market making and ensures a fair distribution of costs (for example, through BSUoS).

Energy UK considers that this option should be taken forward for more detailed consideration by Ofgem. All options put forward by Ofgem would need to be well researched and include proper evidence-based analysis and further analysis would be needed to determine the detailed design elements of any tendered obligation along the lines discussed above.

Option 3: Mandatory auction

Energy UK notes that this option was considered by Ofgem in detail as part of initial S&P proposals in 2013¹. Energy UK considers that the costs and risks associated with this option as assessed in 2013 still remain and, on balance, this option is not an optimal way for improving liquidity in the GB market. Under such a scheme market participants would lose the ability to react in an efficient and timely fashion to changes, creating unnecessary risks and costs. Energy UK considers that this option should not be taken forward for more detailed consideration.

Option 4: Self-supply restriction

Energy UK understands that this option would place an obligation on generators to trade all, or a portion of their output, in the wholesale market. Energy UK notes that the Competition and Markets Authority (CMA) has concluded² that vertically integrated companies trade extensively outside of their own company and this option is unlikely to result in a notable increase in market liquidity. As a result, Energy UK considers that this option should not be taken forward for more detailed consideration.

Should you have any questions, please don't hesitate to get in contact.

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¹ <https://www.ofgem.gov.uk/publications-and-updates/wholesale-power-market-liquidity-statutory-consultation-secure-and-promote-licence-condition>

² <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>