Level 28, One Canada Square
Canary Wharf
London E14 5AB
Tel +44 (0)20.7929.0081

19 September 2017
Matthew Gardner & Hannah Hopper
Market Intelligence and Oversight Energy Systems,
Ofgem 9 Millbank
London SW1P 3GE

By email

wholesalemarketoperation@ofgem.gov.uk

FIA Response to Ofgem Secure and Promote Review: Consultation Paper.

Dear Mark and Hannah

FIA welcomes the opportunity to comment on the Ofgem Secure and Promote Review: Consultation (25th July 2017).

Please find attached a copy of FIA's submission in PDF format.

We would be happy to discuss FIA's response or to answer any questions you may have.

Yours faithfully,

Secure and Promote Review: Response to the Consultation

FIA welcomes the opportunity to comment on Ofgem's Secure and Promote Review Consultation. Our response includes the view of the majority of our members but also reflects the diverging views of another member where applicable. We remain at your disposal for further discussions.

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.

FIA members agree that the price for forward delivery appears to be robust. The membership observes that the concentration of liquidity within the market making window could increase the likelihood of a trader placing an order that is accepted, due to the higher levels of liquidity derived from the window process.

Most members comment that outside of the market making window the order might attract increased regulatory scrutiny under REMIT and MAR requirements as orders in liquid markets are generally handled differently from those in illiquid markets. As a result, those members are concerned that this could discourage trading outside of the market making windows (as it would require adjustment of the way resting orders are handled at different times of the day and in turn could have a negative impact on the liquidity of the market. One member noted that GTMAs are set up so generators and suppliers can trade directly and that there is nothing preventing any trader from trading outside the windows.

There is evidence to suggest the deeper liquidity pools within the market maker window are leading to more robust reference prices. Robust reference prices allow market participants to take a better view on the value of the market and enable the trading of financial products that can be settled against robust physical prices. There is evidence that financial market participants are beginning to re-enter the market, which could lead to increased market churn. This activity should be encouraged and given time to develop.

Ofgem might wish to encourage the availability of transparent wholesale market data in order to support the development and acceptance of industry-wide reference prices. Once these prices are universally available, it is likely that liquidity will grow as financial power activity will increase (as it has in other markets). Such an increase in liquidity may enable Ofgem to relax the Secure and Promote regime thereby reducing costs.

There is also evidence that the business models of some of the original six obligated market making businesses are in the process of changing. Several members commented that further restructures, divestments and plant closures amongst the remaining five obligated parties will no doubt see a greater split of generation and sticky domestic retail portfolios over the coming years and believe that this may bring into question the current approach of applying and apportioning the costs of the licence condition. One member suggested, rather than review the MMOs, Ofgem should consider publishing updated guidance about what constitutes being an MMO. In the near future, new MMOs could be appointed – and others could exit the obligation. That member further highlighted that there are several generation players entering the supply space and believes the Secure & Promote obligation is therefore not seen as an insurmountable barrier to entry in their investment decision.

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.

FIA members agree the availability of physically delivered products to be reasonable. The membership is concerned by the lack of widely available derivatives or cash-settled products and would support initiatives to support the further development of these products in consultation and agreement with the obligated parties.

The majority of GB generation businesses are principally focused on hedging their generation assets and will seek to trade in accordance with an appropriately risk adjusted hedging envelope. This approach minimises their risk exposure across the forward curve and ensures they remain competitive in the traded market. Whilst a continuously traded forward market is preferred, forward hedging activity has moved to the liquidity windows with relative ease – the deeper liquidity pools over shorter trading periods have not materially impacted forward hedging and may have improved access to longer dated products.

Participants are also experiencing reduced hedging capability, particularly in the Industrial & Commercial (I&C) and large commercial sectors. Retailers require access to market products at the time their customers wish to lock in their energy needs. For some members this is proving challenging as product availability is concentrated in two daily liquidity windows. Maintaining open positions until products can be accessed increases risk, thereby costs. One member notes that the two windows have resulted in it being easier to access liquidity, and promote competitive prices in the market.

Furthermore, there appears to be little evidence that the liquidity windows have promoted greater access to non-standard products, for example the availability of shape products, either inside or outside the market maker windows. There is also no evidence of increased granularity across the forward curve, for example access to smaller clip sizes. That said, the Supplier Market Access Rules go some way to resolving these issues for smaller market participants.

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

FIA members consider the near-term market to be relatively liquid. Further, members have observed that the introduction of new participants into the UK market has led to a natural increase in liquidity.

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

FIA members have identified Financial Power Swaps as a factor that should be considered in Ofgem's assessment of liquidity. Financial Power Swaps settle against the average spot power out turn price. This product improves liquidity at the back end of the curve which would benefit counterparties with longer dated hedging exposures.

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?

FIA members captured as an obligated party under the Market Making Obligation (MMO) are required to post bids and offers at regulated spreads during two daily liquidity windows from 10.30 – 11.30 and 15.30 – 16.30. Several members commented that the costs associated with complying with the MMO are excessive, uncontrollable and unpredictable due to the varying market conditions. The high and volatile costs are largely incurred because the MMO parameters such as the Fast Market Rule (FMR) and bid-offer spreads are rigid and result in insufficient protection in volatile market conditions. One member raised that there are new generation participants entering the supply market who are likely to face an MMO and therefore does not believe the costs and risks are sufficient to prevent new entrants in the market. That member further noted MMOs also benefit from Secure & Promote liquidity like all other parties.

FIA members also note that the costs of complying with the MMO during periods of volatility have been significantly higher than the forecasts outlined in Ofgem's impact assessment in 2013, which was undertaken before the introduction of the policy in 2014.

FIA members ask Ofgem to consider making changes to the MMO as a matter of urgency ahead of the expected seasonal (winter) rise in volatility. In periods of high volatility members suggest an interim suspension of the MMO, in whole or in parts and, or an emergency adjustment of the schemes parameters. A temporary suspension or emergency adjustment would enable Ofgem to assess the effectiveness of the changes and open a statutory strategic consultation to review whether the policy is still required or, if permanent changes to the policy are deemed necessary.

Question 6: What are your views on the fast market and volume cap rules, in particular on reducing risk for licensees when needed?

FIA members propose that Ofgem reduces the Fast Market Rule (FMR) from its current 4% threshold. Reducing the FMR threshold would provide a more proportionate trigger to protect MMO parties from negative impacts during stressed market conditions. The membership considers that a reduction in the FMR threshold is unlikely to have a significant impact on liquidity. Further, FIA members recommend that Ofgem considers widening the bid-offer spreads. These changes should improve the resilience of the policy at least for an interim period.

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

No comment.

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

No comment.

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

FIA members infer that the flexibility of obligations in varying market conditions is essential. As noted in other sections, the rigid rules around Fast Markets and relaxation of the MMO simply do not reflect the dynamic way in which the markets work.

FIA members propose that there should be various levels of MMO depending on market conditions rather than simply on or off.

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.

FIA members recognise that the market has changed dramatically since the introduction of the Secure and Promote special license condition in March 2014. For example, liquidity in the GB wholesale market has improved. The structure of the generation market has changed significantly, with many new independent generators having entered the market. This provides suppliers with a much wider market place to purchase power from. Suppliers' access to the market has also improved through the market access-route to market services that are available on commercial terms. The number of electricity suppliers, which the policy was designed to help foster, has also increased significantly[1].

In addition to the structural changes, there have been a number of policy developments including the CMA conclusion[2], REMIT and changes to the cash-out rules. FIA members consider such policy developments to inhibit the potential success of the Secure and Promote policy. FIA members propose that Ofgem conduct an appraisal of the policy to access its continued validity.

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?

FIA members agree that the Secure and Promote special licence condition has concentrated liquidity. However, the membership questions whether the policy has increased liquidity within the market.

FIA members propose that the future of the Secure and Promote license condition should focus on spreading the liquidity from the market making windows across the day. The policy should also focus on developing incentives to create and utilise hedging instruments in addition to the plain vanilla instruments the Secure and Promote policy currently encourages.

FIA members highlight that licensees who are subject to the Secure and Promote license conditions can meet their Market Making Obligations only through posting two-way quotes in the outright UK Base Electricity and Peak Electricity contracts. Further, we note that an important feature of the UK electricity market is that it trades predominantly as a spread to the UK gas markets - 'the UK Spark Spread'.

FIA members propose allowing licensees who are subject to the Secure and Promote license conditions to meet their obligations through posting two-way prices in the UK Spark Spread as well as the outright UK Base Electricity and Peak Electricity contracts.

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

No comment.

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. More information is available on our website: www.fia.org

[1] Ofgem: number of active domestic suppliers by fuel type (GB) https://www.ofgem.gov.uk/data-portal/retail-market-indicators

[2] See point 7.129 to 7.137 of the CMA Energy market investigation – Final report 24 June 2016: "*vertical integration does not appear to have a significant impact on liquidity*