On 9 August 2018 Ofgem published an open letter saying that it was planning to suspend the Market Making Obligation (MMO) which currently supports the efficient functioning of the GB wholesale market.

This paper explains our concern that the proposed suspension of the MMO will result in a substantial deterioration of wholesale market liquidity, significantly increase costs for independent suppliers at a challenging time and just ahead of the winter, thereby reducing competition and increasing costs for GB consumers. Based on our analysis, we expect that removing the MMO will double price spreads, and the cost of hedging, in the GB power market.

We also explain why liquidity is now critically important for the efficient and effective operation of two flagship policies: the proposed retail price cap and the Government’s Baseload Contract for Difference.

To mitigate these risks, we ask that Ofgem:

1. Provides the market with six months’ notice before suspending the MMO, so that independent suppliers have sufficient time to update their hedging strategies and minimise the costs.

2. Closely monitors liquidity following suspension, and launches work with industry now, to quickly develop an alternative liquidity support measure.

3. Commits to implement a balanced and effective alternative in 2019, otherwise the Government should step in with its liquidity backstop.

THE GB ELECTRICITY WHOLESALE MARKET

Electricity wholesale markets play a central role in the electricity value chain. It is where generators compete to sell electricity to supply companies and a competitive wholesale market means that electricity will be supplied to customers at the lowest cost. The market does this by ensuring that only the most cost-efficient generation is running at any moment in time to meet demand, as less efficient generation will be too expensive and won’t be purchased. If a wholesale market is not functioning well, this can act as a barrier to competition and means that costs faced by consumers will be higher.
Policy makers have been concerned with GB liquidity since 2008. At that time the Regulator did a lot of detailed work to identify the costs associated with poor liquidity:

1. reduces the efficiency of the wholesale market
2. creates a barrier to entry in both generation and supply
3. acts as a source of competitive disadvantage to small suppliers
4. reduces competition between industry participants

Initially the Regulator and Government asked industry to take the lead in finding a solution. Eventually, the Government included backstop powers in the 2013 Energy Bill for the Secretary of State to take any necessary action, and in 2014 the Regulator imposed a solution requiring the Big 6 energy companies to act as market makers known as the Market Making Obligation (MMO).

The MMO requires the Big Six to openly trade peak and baseload power products during two daily market making windows. The MMO has improved the efficiency of the wholesale market and helped open the sector to greater competition. Competition has provided greater choice for customers, who can now save as much as £300/year from switching to a new supplier.

However, in August 2018 the regulator surprised the industry by publishing an open letter stating that it was thinking about suspending the MMO, because the structure of the industry has changed since 2014, and it is worried that the costs of the companies that act as market makers may be too high.

The open letter, however, did not mention the negative impact that suspending the MMO might have on the efficiency of the wholesale market, on competition, or the likely cost to GB consumers.

### THE IMPACT OF SUSPENDING THE MARKET MAKING OBLIGATION

As the regulator has not assessed the costs of suspending the MMO for the wider industry and consumers, we undertook our own analysis. The analysis shows that even with the MMO, the GB wholesale market functions less well than equivalent markets in Europe.

We calculated “the cost of hedging” – a measure of market efficiency and competitiveness – to compare the GB wholesale market with that of Germany and France. We found that the GB cost of hedging was significantly higher than Germany, and higher than France. The German wholesale market is the most liquid in Europe, so it was no surprise that the cost of hedging is three time lower than GB. The finding that the GB wholesale market is now less liquid than France is new.

<table>
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<th>Cost of hedging 2017 traded volume</th>
<th>% of time prices available</th>
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<tbody>
<tr>
<td>Great Britain</td>
<td>£137,895,256</td>
<td>57%</td>
</tr>
<tr>
<td>France</td>
<td>€98,349,313</td>
<td>83%</td>
</tr>
<tr>
<td>Germany</td>
<td>€42,804,245</td>
<td>93%</td>
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We also found that, for the standard set of traded products that we looked at, the availability of prices in GB (57%) was significantly lower than France (83%) and Germany (93%). This means that even if a supplier wanted to purchase a power it wouldn’t be able to as there is no price available in the market.

We also calculated the negative impact that suspending the MMO might have on the GB wholesale market. Our main concern is that the GB wholesale market is only liquid for wholesale products (contracts) where trading is required by the MMO.

Based on our analysis we expect that removing the MMO would double price spreads, and the cost of hedging, in the UK power market.

In practice this means that the products that suppliers want to buy are not available throughout the day. The snapshots of the markets below show that even inside the market making window – there are less products available and the volumes traded are lower in GB than in Germany and France. Outside the market making windows the picture is even worse as hardly any trading takes place in the GB wholesale market.

WHY IS A SIGNIFICANT DETERIORATION IN LIQUIDITY A PROBLEM?

Our main concern with the proposed suspension of the MMO is that it will significantly increase the costs to independent suppliers buying electricity in the wholesale market. This would come at a time when some independent suppliers are already struggling, and a major change to industry rules will go-live (on 1 November) that will increase the cost to suppliers who have not fully hedged their positions. As a result, independent suppliers will have to increase their tariffs, and if the MMO is suspended with little notice, Ofgem creates a risk of supplier exits from the market.
The existence of a liquid wholesale market is also critically important for two flagship Government policies. Firstly, Ofgem plan to update the wholesale cost element of the default tariff cap based on reported wholesale market prices. However, if the wholesale market is not liquid then reported price movement will become a less accurate gauge of suppliers’ costs, and the price cap calculation may become materially different from the true costs faced by suppliers. In our view, suspending the MMO will mean that Ofgem’s proposed approach to updating the default tariff cap will become untenable.

“Ofgem’s Secure and Promote licence conditions [...] ensure the availability of the products that were most widely used for hedging”


“Any significant changes, including the removal of the policy, could jeopardise the support on which many rely”

Ofgem’s Secure and Promote Review (2017)

HOW THE CONTRACT FOR DIFFERENCE WORKS

A similar problem exists for the Baseload Contract for Difference (CfD), where the level of subsidy is determined by the difference between a market reference price (the price of forward contacts in the wholesale market) and the strike price of the CfD. It is important that the market reference prices for the Baseload CfD are based on liquid, transparent and robust wholesale markets. The challenge that poor liquidity creates for the efficient operation of the CfD was recognised by the Government when it included back-stop powers to adopt measure to support liquidity in the Energy Act 2013.

Shell Energy Europe: we trade gas, power and environmental products across Europe. In the UK we also supply power to I&C customers and provide credit and market access solutions to independent suppliers.