Issue Form - BSCP40/04	**Issue Number:** 1.0 *(mandatory by BSCCo)*

Issue Title *(Mandatory by originator)*

Could Elexon (under BSCco) administrate a tendered Market Maker (tMM)?

Issue Description *(Mandatory by originator)*

Alongside publication of their commissioned report from NERA[1], Ofgem have published their decision to review market liquidity. The decision to do so comes after suspension of the Market Maker Obligation (MMO) on 18 November[2] due to too few remaining obligated parties. Early research leaves Ofgem and NERA remaining uncertain about whether there is a liquidity "problem" requiring intervention. Ofgem intends to conduct further research over the coming six months to further determine the extent of the "issue".

The MMO was an obligation introduced in 2014 on the largest vertically integrated market parties to make products available so that others were able to hedge at a price that reflected market value. These MMO parties would post the prices at which they are willing to buy and sell a range of mandated products (baseload (BL) and peakload (PL)) for up to two years ahead of delivery. The bid-offer prices were posted for the full duration of two one-hour windows (called the market-making windows) in every business day. This bid-offer spread had a ceiling according to the product type.

While originally there were 6 obligated parties at the time the obligation was suspended there were only two remaining parties that qualified to have an MMO. The obligation was suspended because Ofgem considered it was unfair (and costly) to place the whole burden on just two parties. It was also challenged that the costs of providing the service should be spread across the entire market (i.e. socialised), given the service benefited market participants of all sizes.
There remains a question as to whether the MMO was effective in improving liquidity, and therefore at levelling the playing field and reducing barriers to market entry, or whether it was just an expensive (for the MMOs) experiment.

NERA's report using data from 2019 suggests low liquidity is not necessarily indicative of a market failure that needs to be addressed with a policy tool such as the MMO. However, they also pointed to the increase in bid-offer spreads (the most common measure of liquidity) after the MMO suspension and the higher liquidity in other European markets as indicative of potential market failure that could be addressed. Since then the Covid-19 crisis has further reduced liquidity and it is unclear if this is an underlying trend or if liquidity will recover when the market returns to more normal operations.

[1] https://www.ofgem.gov.uk/publications-and-updates/update-liquidity-policy-review-publication-nera-economic-consulting-options-assessment-report

[2] https://www.ofgem.gov.uk/publications-and-updates/decision-suspend-secure-and-promote-market-making-obligation-effect-18-november-2019

It is also worth noting that the European regulations relating to the internal energy market and capacity markets require that market distortions and failures are suitably addressed. If a market failure exists, then efforts must be made to address it, but arrangements should not create market distortions.

The most obvious solution to a market failure is a return to a mandated MMO or a tendered Market Maker (tMM) option. Ofgem has indicated that a tendered MMO (i.e. a tMM) is the most favoured option among parties they have spoken to, with many recognising the need for a new arrangement to be fair, in that the beneficiaries contribute to costs.

This issue group intends to review the case for ELEXON, as BSCCo, administrating a tendered MM on behalf of the market and, if ELEXON could tender, what sort of service market participants would want a tMM to provide. It is also an opportunity to discuss if ELEXON is not the right party to run a tender for an MM, and then administer it, who may be best placed to undertake this role if required.

Justification for Examining Issue *(Mandatory by originator)*

This MMO policy was originally raised for the benefit of new entrant suppliers, who were struggling to be able to hedge their positions due to a perceived locking off of the market by the larger (at the time six) vertically integrated players who were perceived (rightly or wrongly) to be internally hedging. However, it also helped other parties, such as renewables selling closer to real time.

The market has moved on in the years since the MMO was introduced, and there are now numerous new small generators, as well as even more small suppliers. The number of vertically integrated parties has also reduced substantially.

Market participants remain concerned that there is an “issue” with accessing short term products when parties need them. There has also been an increase in the bid-ask spread seen since the MMO was suspended. This Issue will allow parties to consider if there is a need for a market intervention and what type of intervention would be most beneficial and economic, while Ofgem continue to monitor developments. This could facilitate a more speedy resolution if it is concluded that there is still a problem that needs to be addressed. Further industry discussion may also inform Ofgem’s ongoing monitoring, thereby aiding in delivery of a robust decision.

Suppliers are still generally unable to ensure they are appropriately hedged for volatile (winter seasons) periods. The rash of supplier failures over recent months provide some evidence of this. Small flexible generators are finding themselves relying heavily on the ESO to buy their energy, flexibility and capacity. It is still very difficult for such generators to hedge smaller positions in the short term, never mind month or season ahead. For independent renewable generators relying on longer term PPAs, price discovery is equally important for the competitive pricing of PPAs and provision of liquidity and reference pricing for efficient hedging activities thereunder. Access to a liquid market close to real time also helps renewable generators manage their less predictable output.

Further, triads signals are being removed with residual TNUoS payment reform. Suppliers will be under pressure to ensure that they are hedging those positions that were previously met by demand reduction (or increased generation). They, and their counterparties will need an efficient means of price discovery to ensure that a healthy market emerges that enables full and fair competition for everyone. The proposer is of the view that the products mandated under the MMO were insufficiently broad to meet the needs of the emerging market players. Suppliers, flexible generators and demand side response would benefit from a liquid market with price discovery over shorter (EFA block) periods in the forward market (days, weeks, month and season ahead) and independent suppliers and renewable generators would benefit from a wider reach of mandated products (including multiple seasons ahead for baseload products). BL and 12 hour PL products do not sufficiently address the needs of these parties. European regulations require that countries facing supply shortages such that they require a capacity market, reform their electricity market to ensure that it is functioning as efficiently and as free of distortions and market failures as possible. Ensuring efficient and “true” price discovery and enabling parties to hedge at the same price as their competitors is a part of that solution.
Potential Solution(s) *(Optional by originator)* The proposal is that ELEXON as BSCCo would, with the help of parties, define a market maker role to be filled and then administer a tendered market maker. It would also be responsible for managing the contract with the tMM company. It is already responsible for managing contracts with BSC service providers and the cash flows for the balancing market and so would be well placed to take on the task. However, consideration could also be given to the pros and cons of other parties running a tender. For the group’s consideration: • Is Elexon the appropriate body to tender for a commercial MM? If not who should tender if Ofgem were to go down the tMM route again? • What would the tender look like? Live auction? Sealed bid? Paid as cleared or bid? • What products should be included? • Would a tMM involve financial regulation? And if it does, do the associated costs and risks make the solution inefficient? Is there a version of a solution that would limit exposure to financial regulation? • How quickly could a solution be implemented? Could it be implemented in stages? • How much would it cost to implement? • Who will pay for it and how? • Will there be any parties that disproportionality win or lose? (Customers, small/large generators, suppliers? Renewables? Interconnectors?)

• Are there other market interactions not considered? Balancing services, TERRE? • Are there other regulatory or code areas that would interfere with implementation? • Should the tMM be reviewed to check it is still necessary and if so at what interval and by whom.
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