



Response to SEM Consultation Paper SEM-10-084

Consultation on SEM Market Power and Liquidity

on behalf of

AES Kilroot Power Ltd and AES Ballylumford Ltd

22 March 2011

1. Introduction

AES Kilroot Power Limited (“AES Kilroot”) and AES Ballylumford Limited (“AES Ballylumford”) (collectively “AES”) welcome the opportunity to comment on the Consultation on SEM Market Power and Liquidity.

AES’s portfolio of generation in Ireland totals 1,831 MW comprising 618 MW at AES Kilroot and 1,213 MW at AES Ballylumford (capacity figures provided on a sent-out basis). Over half of this portfolio of capacity (931 MW) is currently under contract to NIE Energy Power Procurement Business (“PPB”) via Power Purchase Agreements (“PPAs”) and PPB is responsible for the commercial activity of such contracted units within SEM. The remaining capacity is traded by AES on a merchant basis within the Single Electricity Market (“SEM”) and comprises:

- Two dual rated coal/oil fired units at Kilroot (476 MW);
- Two gas fired thermal units at Ballylumford (340 MW); and
- Two distillate fired OCGT’s at Kilroot (84 MW).

Since SEM Go Live, PPB have provided important Non-Directed Contract (“NDC”) offerings to market participants, on the back of PPA contracted plant and these contracts have made a significant contribution to providing hedging opportunities primarily for suppliers within SEM.

The position of AES Kilroot’s non-contracted plant within the SEM merit order, relies on the extent of dark spread in SEM, and given current commodity prices such dark spread looks uncertain and limited in the near term (although this can quickly change given the volatility in commodity markets). Consequently AES’s merchant fleet currently occupy a marginal and/or peaking position with SEM merit order. This, along with the current industry structure and lack of contract liquidity and forward curve, has limited our ability to offer hedging contracts to date. AES do however see the benefit of being able to lock in margin and we support any efforts to reduce/mitigate market power and improve and deepen contract liquidity.

2. Executive Summary

- AES believes that the established objectives and criteria for the Market Power Mitigation Strategy are fit for purpose in the current SEM context.
- AES believes that, at least in theory, more substantial bi-directional interconnector capacity between Ireland and GB should facilitate increased competition within SEM. However, given the current DECC consultation on Electricity Market Reform and HM Treasury’s proposals for a carbon price floor the impact on competition and liquidity within SEM is difficult to assess at this point.
- The lack of forward curve and contract liquidity in terms of players and short term products etc hinder AES’s appetite and ability to offer contracts given the current SEM design and market structure.
- Following the cancellation of the Generating Unit Agreements (“GUAs”) for AES Kilroot’s coal fired units, PPB’s portfolio of plant has changed in terms of reduced capacity and diversity of fuel type. Consequently, it may be that the volumes and range of products offered by PPB in the next round of NDC auctions, is reduced, further eroding liquidity within the market.

- The Public Service Obligation (“PSO”) Directed Contract (“DC”) process has also delivered important volume within the contract market and it is disappointing that the Regulatory Authorities have not published their paper clarifying their position on the availability of PSO-related Contracts for Differences (“CfDs”). This paper was to be published on the 7th February 2011 and unfortunately it has yet to be published. In the absence of such a paper, we cannot comment fully on the potential options for reforming DCs, other than to say if PSO backed DC’s are not made available liquidity within SEM will reduce significantly.
- There may be some merit in removing the Economic Purchasing Obligation (EPO) condition so long as there is demonstrable effective and efficient competition to ensure that ESB Customer Supply (“ESBCS”) and NIE Energy Supply (“NIEES”) seek to contract on a basis which ensures they offer best value to customers.
- Cambridge Economic Policy Associates Limited’s (“CEPA’s”) detailed analysis and report clearly indicates that ESB’s reintegration proposal has a substantial negative impact on competition both in terms of market concentration and the Residual Supply Index (“RSI”) metrics. Furthermore, CEPA also acknowledge that reintegration is likely have a substantial detrimental impact on contract liquidity within SEM. We strongly agree with CEPA’s points and believe that complete reintegration is contrary to the aims and objectives of this market power and liquidity review project.
- ESB’s liquidity proposal highlights the fundamental issues with reintegration and whilst we believe it is helpful that ESB have offered this proposal we share CEPA’s view that it merely serves to mitigate a power that ESB does not currently have due to the established ring fencing obligations.

3. General Comments

RA’s and Participants alike are currently trying to assess the impact of a number of key work streams which are likely to have a significant impact on the evolution of SEM:

- Accommodating ever increasing levels of wind and other renewable generation;
- Medium term review of the Capacity Payment Mechanism;
- Compliance with EU Congestion Management Guidelines and broader EU policy of market coupling and regional integration;
- Extent of infrastructure constraints within and across the transmission systems in Northern Ireland (“NI”) and the Republic of Ireland (“ROI”); and
- Ongoing review of state owned assets within ROI.

In addition, the UK Government has just completed a consultation exercise in relation to proposed Electricity Market Reform which includes a floor price for carbon. This reform could have significant implications for Participants in NI and on the operation of interconnector flows and electricity prices in the SEM.

Given the uncertainties associated with these key strategic issues, it is difficult to assess the issues presented in the consultation paper in relation to impacts on market power and liquidity. This is particularly so in the medium/long term.

We have not therefore attempted to consider the impact of each of these important issues and have deliberately limited our response to the questions posed by the RAs in the Request for Comment section of the consultation paper.

4. RA Specific Questions

Q1. AES believes that the established objectives and criteria for the Market Power Mitigation Strategy are fit for purpose in the current SEM context. The market power mitigation measures are comprehensive and given the current market design and industry structure are essential in ensuring that SEM delivers a competitive market, devoid of abuse of market power and ensuring generators adhere to market rules and Licence obligations in relation to bidding at Short Run Marginal Cost.

We welcome the separate consultation on the MMU Governance Process Manual and we would continue to encourage a more proactive and transparent approach to market monitoring.

As outlined in section 3, elements of the SEM design and also industry structures may change significantly in the medium term and the Market Power Mitigation Strategy will need to be reviewed and assessed in light of any future changes.

Q2. AES believes that, at least in theory, more substantial bi-directional interconnector capacity between Ireland and GB should facilitate increased competition within SEM. However, given the current DECC consultation on Electricity Market Reform and HM Treasury's proposals for a floor price for carbon the impact on competition and liquidity within SEM is difficult to assess at this point. The effect on competition within SEM will also be significantly influenced by the final Trading and Settlement Code rules in relation to Intraday Trading and the broader EU strategy of regional integration and market coupling.

The market power mitigation strategy may need to be reviewed to take cognisance of which players are trading across interconnectors and to what extent their capacity holdings/trading could represent opportunities to exert market power.

Q3. The demand for hedging products in SEM is driven by the needs of both suppliers and generators, particularly those parties who are not vertically integrated. Suppliers want to manage System Marginal Price ("SMP") price volatility to allow them to develop appropriate tariff structures to customers, whilst generators are often keen to lock-in margin to provide a higher degree of certainty in relation to business planning and managing working capital.

AES is a non-vertically integrated player within SEM, with a portfolio of merchant plant which is currently marginal and/or peaking in nature (given prevailing commodity forecasts) – this merchant fleet excludes AES Ballylumford CCGTs which are contracted to PPB. As a result the need for, and opportunity to, hedge energy margin is currently very limited for AES. Furthermore, the sensitivity of our coal fired units to gas-coal spread and the volatility of global commodity prices (including carbon), brings significant risk if we were to enter into upstream fuel hedges as we will have both price and volume exposure in SEM. The lack of contract liquidity in terms of players, forward curve, short term products etc all hinder our appetite and ability to offer contracts at the moment.

We note that in previous years PPB have made a significant contribution to contract liquidity within SEM, primarily through the NDC auctions but also the DC process in 2008. Following the cancellation of the PPAs for AES Kilroot's coal fired units, PPB's portfolio of plant has changed in terms of reduced capacity and diversity of fuel type. Consequently, it may be that the volumes and range of products offered by PPB in the next round of NDC auctions, is reduced, further eroding liquidity within the market.

Q4. As stated previously DCs were initially aimed a mitigating ESB's potential to exert market power but

they have become one of the primary mechanisms for delivering hedging opportunities within the SEM contract market. Reform of DCs does seem appropriate particularly in relation to improving the range and granularity of products, shortening delivery periods and improving the overall transparency and governance of the DC process.

The PSO DC process has also delivered important volume within the contract market and it is disappointing that the RA's have not published their paper clarifying their position on the availability of PSO-related CfDs. This paper was to be published on the 7th February 2011 and unfortunately it has yet to be made available. In the absence of such a paper, we cannot comment fully on the potential options for reforming DCs, other than to say if PSO backed DC's are not made available liquidity within SEM will reduce significantly. We understand that the concern in relation to PSO backed DC's relates to a legal issue and exposure of ROI customers to under-recovery of costs against PSO contract costs. An obvious way to over-come this issue would be for ESB and the RAs to include a risk premium within the PSO DC price to ensure that cost exposure is mitigated.

In relation to the choice of the Herfindahl-Hirschman Index ("HHI") versus RSI, we note CEPAs comments in their report and from an AES perspective both means of analysis have their advantages and disadvantages. We believe that there is merit with continuing to use HHI in the short term as the way of measuring market concentration, as without significant changes to the industry structure, ESB Power Generation are likely to remain the only party required to offer DCs. Obviously, as the market design and structure evolves there may be a need to review how best to determine DC volumes including which is the most appropriate metric.

Q5&6. AES understands that full retail competition is now in place for ESB's business customers and NIEES customers with an annual demand above 150MWhs. Given the strong desire of RAs and participants alike to move to competitive de-regulated markets, there may be some merit in removing the EPO condition so long as there is demonstrable effective and efficient competition within each customer sector.

Q7&8. CEPA's detailed analysis and report clearly indicates that ESB's reintegration proposal has a substantial negative impact on competition both in terms of market concentration and the RSI metrics. Furthermore, CEPA also acknowledge that reintegration is likely have a substantial detrimental impact on contract liquidity within SEM. We strongly agree with CEPA's points and believe that complete reintegration is contrary to the aims and objectives of this market power and liquidity review project. Consequently we would not be in favour or support of either vertical or full integration of ESB Group.

We are mindful that the Minister for Finance has appointed "The Review Group on State Assets and Liabilities" and that this review is ongoing. Without trying to predict the outcome of this review, there may be some divestment activity of state owned assets in the not too distant future. Appropriate divestment may (depending on what is divested and to whom) help improve the competitive position of SEM and possibly facilitate the development of improved liquidity.

It is a stated aim of RAs, both Governments and EU to increase competition within energy markets. We would have significant concern that if full reintegration of a state owned incumbent such as ESB Group was to be approved by RAs, then this could undermine external investor confidence in the Irish energy market. New investment will be essential in terms of not only improving competition but also complying with renewable targets, emission targets and ensuring system security is maintained in the long term.

The EU's 2009 Further (Third) EU package of Directives and Regulations aim to speed up opening of electricity and gas markets particularly in relation to requiring the unbundling of

network operation, from network ownership, generation and supply. Reintegration seems to be inconsistent with these Directives and Regulations.

Q9. In relation to “mandating all generators to offer contracts and/or to become market makers” we have substantial concerns in relation to:

- How this would work within the current SEM design and industry structure (small in size, high levels of vertical integration and single player with substantive market concentration);
- Risk exposure for lower merit order/peaking generators (e.g. how are liabilities/losses associated with being over contracted addressed/mitigated?);
- Higher levels of regulatory intervention and risk; and

In the absence of further detail it is difficult to comment further other than to say that this approach would not be welcomed or supported by AES within the current design and structure of SEM.

Q12. ESB’s liquidity proposal highlights the fundamental issues with reintegration and whilst we believe it is helpful that ESB have offered this proposal we share CEPA’s view that it merely serves to mitigate a power that ESB does not currently have due to the established ring fencing obligations. Furthermore, if ESB was reintegrated they would have even more market power as both a buyer and seller (including access to information) and it is not clear to us how their liquidity undertaking would work in relation to transparently setting volume, prices, forecast demand etc. There are a range of other questions as to how the process would be governed, what form contracts would take and the very real danger that a single entity will be aware of many other participants’ commercial position.

ESB have recently issued proposals in relation to working towards establishing an Over the Counter brokered market for SEM CfDs and we welcome this development. However, we have not reviewed ESBs proposals in great detail as part of our response to this consultation paper. Nevertheless, AES welcomes ESBs proposals and would be keen to work with ESB and other Participants to take this work stream forward, however this should happen irrespective of whether reintegration happens or not.

Q13. At this stage it is difficult to predict the impact of increased wind penetration on the demand for contracts and need for market liquidity, particularly given the other strategic market issues outlined in section 3.1. SEM, its Participants and Customers face substantial uncertainty in the near and medium term, but intuitively a more liquid market should help Participants mitigate some of their price exposure within SEM and improve the efficiency of the market. With a substantial roll out of wind (particularly ahead of sufficient infrastructure) there is a very real risk that market pricing and scheduling will reward plant in a way which does not accurately reflect its value to the system. The RAs have acknowledged this risk recently in their consultation paper “Monitoring the Divergence of the Market Schedule from Dispatch and the Impact on Consumers”. High levels of wind will push mid-merit plant towards the margin, creating high levels of uncertainty in relation market scheduling and increasing volume risk to those Participants who have been offering contracts on the back of mid-merit plant e.g. PPB. In addition a high level of wind penetration is likely to increase the volatility in SMP, further increasing risk to parties looking to enter contracts. High levels of liquidity would help manage this uncertainty however current market structures (ESB dominance, vertical integration etc) would seem to present a substantial challenge to deepen liquidity within the market. One final point of note is that wind generators tend to be price takers within SEM and have no upstream fuel exposure. It is therefore unlikely that wind generation Participants are likely to look to offer CfDs and liquidity is likely to diminish further with increased levels of wind penetration unless there is a significant change to market structures, rules and/or number of participants.