22nd March 2011

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RE: Consultation on SEM Market Power and Liquidity

Dear Andrew, Paul,

Thank you for the opportunity to respond to and input into the Regulatory Authorities (RAs) consultation and review of market power and liquidity in the Single Electricity Market (SEM).

As outlined by CEPA in its report, the SEM is a relatively small market. Market power and the potential to exercise it, is more threatening and has wider consequences in such a small market. Furthermore, the instantaneous nature of electricity production and consumption make the market particularly susceptible to market power. It is therefore imperative that market power and the threat of market power are **prevented** if the competition in the retail and wholesale markets that have been developing of late is to continue.

Ofgem and FERC have in the past number of years considered the implementation of a number of measures to address market power abuse in their respective markets. Both regulatory authorities have acknowledged the difficulty in identifying market abuses after the event and therefore sanctions can and have proven difficult to apply in cases that were investigated. With this in mind, Bord Gáis Energy (BG Energy) is of the view that it would be more prudent to ward against the potential for market abuse as opposed to taking action ex-post. That is to say, although the ESB may not be found to exercise its market power potential at this time, it is important for the credibility of the SEM, the development of competition and future investment that this potential is minimised and prevented as opposed to addressed ex-post after an event.

With respect to the specifics of the consultation paper, it is BG Energy's view that the analysis and conclusions outlined in the consultation paper do not fully consider and appreciate certain recent market developments and implicit market characteristics of the SEM, namely:

- The portfolio advantage held by ESB relative to all other generators in the market;
- The impact of the likely termination of PSO backed CfD contracts on liquidity and ultimately retail market competition;
- The impending deregulation of the ESB's supply businesses,
- Recent NDC pricing and premiums, and

- The components of the SMP which need to be hedged by suppliers; uplift is a considerable proportion of the SMP and therefore dirty hedges would not provide adequate risk management measures for suppliers seeking to compete in the retail market.

On this basis, BG Energy does not believe that the analysis and conclusions fully reflect the reality of the market for suppliers and generators and the full potential of ESB's ability to abuse its position to the detriment of competition in the retail and wholesale markets. For example, allowing ESB to vertically integrate at this time would remove transparency from the market in terms of how ESB Customer Supply hedges its customer portfolio. Yet, as the single biggest provider of hedge contracts in the market, ESB would have first hand data on the volume and price of hedge contracts held by its direct competitors. This would bestow a further significant competitive advantage on the incumbent and remove any level of transparency or equity in the market. This point will be addressed in greater detail in our answers to Q4 and Q5 relating to hedge requirements and the ESB's EPO below.

In summary, BG Energy fully supports the RAs initiative to assess market power and the potential for market power. Combined with the other SEM Committee consultation on market monitoring governance, these consultations send a strong signal to the market that the RAs are actively monitoring and will take action against market power abuses or infringements. This instils confidence in the market and sends positive signals to investors and potential new investors. The benefits of these initiatives would be eroded if the RAs were to permit changes to the market structure. The reintegration of the ESB's generation and retail business divisions would be a significant change to the structure of the SEM. Furthermore, BG Energy does not believe that the ESB's proposals to provide liquidity in a reintegrated market framework will adequately prevent the potential for market abuse. Therefore and for all of these reasons, BG Energy does not support the vertical reintegration of the ESB at this time.

Attached are BG Energy's views and proposals on the specific questions asked by the RAs in the consultation paper. We are available to meet with you and your colleagues if you would like to discuss any of the issues raised or proposals made further or indeed if you require clarity or have any further queries.

Yours sincerely,

Jill Murray
Regulatory Affairs – Commercial
Bord Gáis Energy

Bord Gáis Energy
think beyond

APPENDIX

Q1. Do the objectives and criteria for the Market Power Mitigation Strategy remain appropriate today and for the foreseeable future?

Absolutely, market power mitigation is imperative for the credibility of the market. Empirical evidence from other markets clearly shows that the need for mitigation is a feature of electricity markets and their inherent instantaneous characteristics. In order to protect the interests of customers through the promotion of effective competition, it is imperative that these markets function effectively and credibly. Market power has the potential to damage competition and raise costs to customers, therefore it is as relevant now as it was during the development and implementation stages of the SEM, that market power is mitigated and warded against.

Q2. Will the new interconnector facilitate more competition from Great Britain? If so, what will be the impact on the appropriate market power mitigation strategy?

The interconnector (IC) will only provide liquidity for as long as SEM prices are higher than GB market prices. If this was to be reversed, the IC could actually diminish liquidity as opposed to adding to it.

It is fair to say that the IC has the potential to offer greater liquidity to the SEM but that is dependent on a number of features, namely; the ability to access capacity and also the price for that capacity. Market arrangements for access to IC capacity must be transparent and parties must not be allowed to monopolise the asset. It is also important from a market monitoring perspective that trading across the IC, which has more lenient bidding rules, is monitored more closely to ensure that SEM prices are not manipulated. With this in mind, the MMU will need to be more vigilant in its monitoring of the ICs and how it affects prices as trading on the IC increases and IC trades account for a greater proportion of SEM volumes.

It is important that any new IC rules do not strand generation in the SEM to the detriment of the long term liquidity of the SEM.

Q3. It would be helpful if market participants could explain why they believe demand for hedging products in the SEM exists, and how this demand is not addressed by alternative hedging options, such as through fuel markets.

Suppliers entering the retail market look to build up a portfolio of customers and in so doing must also build up a portfolio of hedge contracts to manage the risk of wholesale market volatility. Customers traditionally and in the current market environment seek price certainty on a medium to long-term basis and in order to provide this certainty, suppliers must hedge their wholesale positions actively. In the nascent stages of competition and as customers switch to and from suppliers it is imperative that a supplier can manage its portfolio and thus its hedges on long-term basis but also on a more frequent and short-term basis, even down to weekly and daily hedges (this is becoming increasingly important with the expected introduction of global aggregation where suppliers will also have to actively manage its exposure to balancing and error values).

Dirty hedges using fuel commodity markets are not an adequate risk mitigation measure. The SMP, which suppliers are trying to hedge, is a function of fuel costs and uplift. Uplift is becoming an increasing large proportion of the SMP and therefore and increasingly important factor of a robust hedging strategy. Dirty hedges therefore will not adequately allow a supplier to hedge its wholesale market risks. In order to hedge uplift, a supplier must either have a portfolio of physical generation in the market or hold contractual hedging agreements (CfDs) with generators running in the market.

Q4. In what way could DCs be reformed in order to promote contract liquidity while also mitigating market power? Do you see merits in replacing the HHI with the RSI in determining DC volumes?

In order for hedge contracts to provide the required liquidity for the market they must be accessible on a frequent basis for both short term and long term contracts, they must be tradable and the price setting mechanism must be transparent and market based. DCs were originally provided to mitigate ESB PGs market power position and NDCs have been provided as a complimentary measure to provide greater levels of liquidity. In BG Energy's view and as outlined it its numerous responses to the CER's consultation on a Roadmap for the Deregulation of the Retail market and also to the SEM Committee's previous State of the Nation review paper, neither of these initiatives provide adequate levels of liquidity for suppliers. However, what the current structures (both of the market and of the ring-fenced ESB) do provide is a platform where ESB PG must offer its hedge contracts to the market in a transparent and non-discriminatory manner. This has, in BG Energy's view, allowed retail competition to commence, however, in order for it to develop further such that it is sustainable, the provision of hedge contracts needs to be enhanced further such that a liquid and transparent platform allows suppliers to trade actively with other wholesale and retail participants.

In its endorsement of DCs in its previous response, BG Energy was referring to the price setting mechanism used for DC contracts, which although not fully reflective of market realities, are to an extent transparent when compared to the NDC offerings. The optimal solution for the market would be the provision of market-based contracts which do not need direct regulatory intervention. However, until such time as this level of liquidity and transparency can be developed by the market, the DCs should be made more frequent and be tradable.

With respect to the use of the HHI and RSI, BG Energy recognizes merits in both measures and indeed academic studies suggest that it is "desirable to have a range of techniques[1]" when assessing market power.

Q5. Does the recent removal of the EPO condition from ESBCS for business customers and the earlier EPO removal from NIEES for customers with an annual demand above 150 MWhs, together with the removal of ring-fencing between ESBCS and ESBIE, negatively impact on the SEM spot or contract markets? If you consider that it does, are there any replacement conditions required in the SEM and what should they be?

The removal of EPO conditions on the incumbent suppliers should not affect the contract or spot markets, provided that the previously regulated incumbents are required to purchase their energy and hedge contracts in the market on a transparent and non-discriminatory basis as per all other competing suppliers. It seems reasonable that in a competitive market all suppliers should be allowed to purchase and hedge without restriction. However, if the ESB was to be vertically reintegrated, this market and its transparency would be dissolved and the incumbent would have a significant competitive advantage over other market participants. Not alone would it remove transparency from the market, it would give ESB Customer Supply a competitive advantage relative to its competitors and provide it with insider knowledge of a competitors commercial strategy.

Q6. Do you consider that the planned forthcoming removal of the EPO for domestic customers in Ireland will have an adverse effect on competition and liquidity in the SEM spot or contracts market? If so, what replacement would you recommend for the SEM? Would the removal of the EPO from NIEES for customers below 150 MWh per annum in NI have a similar impact – and if so, what replacement would you recommend?

Please refer to question 5.

Q7. What if any, implications for competition/ end customer do you see arising from ESB's proposed reintegration:
a) Horizontally,
b) Vertically,
c) Horizontally & Vertically.
What, if any, new measures would you recommend be put in place for each of the above forms of integration?

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1 '*A Review of the Monitoring of Market Power: The Possible Roles of Transmission System Operators in Monitoring for Market Power Issues in Congested Transmission Systems'*, 2005, Twomey, Green, Neuhoff and Newbery, Journal of Energy Literature, Vol. 11, No. 2, pp. 3-54.

BG Energy strongly believes that the options to vertically integrate any part of the ESBs business units (options b and c above) will severely and adversely affect competition in and the credibility of the market.

Proposals to vertically reintegrate any aspects of the ESBs business will overturn the objectives of the SEM Committee's Market Power Mitigation Strategy and will enhance the potential for ESB's position of market power to be abused. Despite the proposals provided by ESB PG, BG Energy firmly believes that any form of vertical reintegration at this time will stymie the development of liquidity/forward market contracting and will revert a level of market power to the incumbent who would then be in a position to use that power to affect competition and prices in both the wholesale and retail markets. As stated previously, the interests of customers and competition are better protected if the exercise of market power can be **prevented** as opposed to identified and addressed after an event.

Q8. Would further divestment by ESB encourage deeper competition in the wholesale market?

Further divestment of ESB could actually reduce liquidity in the market further at this time and until such time as a platform for market driven liquidity is provided. For this reason, BG Energy would prefer to see the provision of more CfDs as opposed to the divestment of ESB at this time.

Q9. What are the current incentives on generators and suppliers to offer and purchase contracts? Are there any impediments to trading contracts? Do you agree with mandating all generators to offer contracts and/or to become market makers? If not all generators, what criteria would you use for mandating generator to offer contracts or to become a market maker?

All suppliers, including a ring-fenced ESB CS, are incentivised to purchase hedge contracts on the basis that they are short on power and need to hedge against the risk of wholesale price volatility. As outlined in our response to question 3, dirty hedges do not provide a sufficient hedge against the market risks to which suppliers are exposed. Therefore, suppliers must seek counterparties, with physical assets and who are actually dispatched in the market, to hedge against market risk effectively.

BG Energy would welcome a platform which would allow parties to trade their hedge positions out on an ongoing basis. This could provide good short-term liquidity to the market and again would allow all parties to actively trade their positions as they change.

In terms of mandating all generators to offer contracts, BG Energy understands that this proposal is being considered by Ofgem in GB but does not believe that it would be appropriate in the SEM. Firstly, no other generator in the market holds a portfolio similar to the ESB. The ESB essentially has a monopoly holding of mid-merit and peaking plant and therefore mandating other generators to provide contracts would only increase the number of baseload contracts offered. Suppliers need mid-merit and peaking contracts to manage customer portfolios effectively, therefore such an initiative would do little to improve upon the current provisions for suppliers.

Also and as a result of the central dispatch nature of the SEM and increasing levels of intermittent generation, generators cannot forecast their running schedule or whether they will actually be in merit. Therefore, they cannot commit to offer hedge contract volumes or if they were to it would be an open-ended risk if they were not in the merit order. ESB, with their portfolio of fuel and plant type, can to a greater extent reasonably expect to be in merit and therefore are in a better position to forecast available volumes. This also makes the ESB the only viable generator in providing the market maker function. Again, ESB would not be incentivised to tender for such a role if it was vertically reintegrated as its generation and supply businesses would seek to hedge internally as opposed to on a transparent and non-discriminatory market platform.

Generator participants in the market have been engaging collaboratively in an attempt to spark greater liquidity in the market through the provision of a flexible platform which would be accessible to all market participants. To progress this initiative further and to drive the debate and development in a more timely manner, it may be opportune at this time for a regulatory-led, market-wide working group to be established. Such working groups, which have been established as part of the Modification Committee structure, have proven useful of late in achieving solutions for the market which are both practical and acceptable to all market participants.

Q10. What product types and in what proportions should a minimum specification market maker offer? What eligibility restrictions should there be to trading with market makers?

The contracts and products provided to the market should facilitate the further development and sustainability of competition. Although BG Energy would not see much merit in offering products of 0.1MW, if certain market participants required such a facility, BG Energy would have not objection to their provision in the market.

Again, in terms of eligibility criteria and product offerings, BG Energy would urge the RAs to facilitate a market working group to discuss the issue of liquidity in an open and directed manner. We feel this would allow all parties, those offering contracts and those seeking contracts, to discuss their needs and limitations, which would ultimately help in finding a solution to the current liquidity problems.

Q11. Do you agree with the CEPA analysis of the ability of structural remedies to address the competition problems presented by the hypothetical structural scenarios outlined in section 6 of the accompanying paper?

There are certain shortcomings in CEPA's analysis outlined in section 6 of the consultation paper. Firstly, their analysis does not assess the impact any of the options will have on the development of competition in the retail market. It is widely accepted that accessible and liquid wholesale markets are a pre-requisite for sustainable retail market competition. In BG Energy's view, CEPA's assessment is incomplete as it does not capture the full extent of the impact of reintegration on the energy market as a whole.

Furthermore, CEPA's analysis does not capture the significance and the impact of the termination of PSO backed CfDs on the market. Again, this renders their analysis incomplete and therefore the market power metrics presented are not a true reflection of the state of the market.

With respect to CEPA's specific assessments of the different options, BG Energy broadly agrees with its recommendation; to allow the market to absorb the future expected and mandated changes before agreeing to the reintegration of the ESB. BG Energy also concurs that behavioral remedies to market power mitigation will not be sufficient or give sufficient comfort to market participants and potential investors that the potential to exercise market power (which is still found to exist under both HHI and RSI analysis) will be abated.

BG Energy agrees with CEPA's assertion that the BCOP does provide a certain level of market power mitigation, however, that is only effective if noticed by the MMU or brought to the MMU's attention by other participants and only addresses market power in the spot market. Joskow and Kahn (2002) advocate that forward market contracting also has a role in mitigating market power and that parties who have contracted volumes forward have fewer incentives to exercise their potential to manipulate the market. Until such time as a robust platform or robust arrangements to facilitate market liquidity are established, the market cannot be expected to govern market power effectively.

Furthermore, market analysis, using both HHI and RSI clearly indicate that ESB PG still holds a position of market power in the SEM. For this reason and given that the deregulation of the ESB's retail business has only recently been approved, BG Energy does not believe that the current structural features should be relaxed to allow ESB reintegrate its generation and supply businesses.

Q12. Will ESB's liquidity proposal be effective in assisting contract liquidity in the market if it is allowed to vertically and horizontally integrate? Will this proposal facilitate competition in the wholesale and retail market? If so, why? If not, why not?

The liquidity proposals outlined by ESB in their submission to the SEM Committee will not address the structural issues that exist, which absent regulatory intervention, inhibit the development of effective liquidity in the SEM.

Firstly, it will not provide transparency to the market as to what volumes will be provided on an ongoing basis and when they will be provided. More importantly, ESBs proposals do not outline the pricing mechanism that will be used or that will underpin their proposals. Price is a critical factor in the provision of liquidity and transparency in the price setting mechanism and inputs is imperative for the credibility of liquidity arrangements. In several recent NDC auctions the clearing price has been underpinned by premiums, which as a buyer in the market, did not reflect market sentiment. Transparency is needed such that buyers can understand the make-up of prices and the associated premiums; otherwise they will view the products as over-priced and will not trade in the market.

With respect to liquidity provisions, ESB assume that "weekly or daily products would face insufficient demand and would reduce availability of more critical monthly, quarterly and annual products". This is an unsupported assumption and given the impending changes to error supply units, global aggregation, increased levels of customer switching and the uncertainty surrounding generation fleets, BG Energy believes it is an inaccurate view of the market and the requirements of market participants. Yet again, BG Energy would suggest that a market working group would allow all of these issues and requirements to be discussed openly such that arrangements can be progressed, developed and implemented to compliment and enhance the SEM and competition in the SEM.

Q13. Will increased wind penetration affect demand for contracts and the need for market liquidity?

Market participants and the System Operators have over the course of the past 12 months been discussing the impact of intermittent generation and interconnection on the operation of the SEM. It is difficult at this stage to fully appreciate the impact they will have in a centrally-dispatched, day-ahead market. However, all parties are agreed that it will make forecasting and scheduling more difficult and volatile. It will not affect the demand for contract volumes from suppliers as they will still need to hedge wholesale price volatility on an ongoing basis, but it may impact the demand for contract types and duration. At this stage and until such time as there is a better understanding of how the market and dispatch schedules will be impact, it is difficult to assess to what extent the demand for contracts will be affected.