22nd March 2011

Mr Andrew Ebrill,
Commission for Energy Regulation.
The Exchange,
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Mr Paul Bell,
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Via email

Re: SEM-10-84

Dear Andrew, Paul,

Endesa Ireland welcomes the opportunity to respond to the Consultation Paper on SEM Market Power and Liquidity.

To date, Endesa Ireland considers that the market has generally worked well in fostering competition and attracting new entry. However, contract liquidity has been slow to progress. Now that the market has bedded down and average prices are reasonably stable, we would expect liquidity in the contracts market to improve.

A competitive, liquid and transparent contracts market is an essential requirement in realising a fully competitive retail market and in attracting new market entry. As the incumbent companies continue to have a substantial share of the wholesale market, Endesa Ireland considers that the RAs must continue to have a vital role in the development of this market.

1.	Do the objectives and criteria for the Market Power Mitigation Strategy remain appropriate today and for the foreseeable future?
	Endesa Ireland considers that the objectives and criteria of the Market Power Mitigation Strategy are appropriate for the foreseeable future. Endesa Ireland considers that the medium to long-term strategy of the RAs should be to relax and eventually remove the regulatory tools designed to mitigate market power as the SEM develops and the market shares of the incumbent generators fall. Relaxing the bidding principles should be examined for independent players in the medium-term and for both independents and incumbent companies in the longer term. Strict bidding principles

	or rules may be stifling innovative bidding strategies which deny end-customers the full benefits of a competitive market. However, this would require a significant change to market rules and should be signalled well in advance of implementation. Endesa Ireland notes that the potential for market power in the contracts market (eg financial withholding) is something the RAs do not appear to have examined yet – we believe it would be worthwhile to examine this issue.
2.	Will the new interconnector facilitate more competition from Great Britain? If so, what will be the impact on the appropriate market power mitigation strategy?
	Endesa Ireland believes that increased interconnection and market coupling with GB should have positive effects on contract liquidity and competition. The extent of the positive impact will largely depend on the capacity access arrangements and the success of the RAs, Ofgem and other key players in adapting the SEM and BETTA market rules to allow for efficient cross-border trading. A number of barriers to entry for interconnector trading were identified in the RAs' consultation paper on Regional Integration (SEM-09-096). Endesa Ireland considers it is imperative that these barriers to trading are addressed prior to the commissioning of the East-West Interconnector, which will help to improve liquidity in the contracts market.
3.	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.
	Endesa Ireland considers that demand for hedging products in the SEM exists because fuel hedging does not cover the full price risk generators are exposed to, for example the risks due to SMP volatility, including the risk that SMP would be zero. It is also worth bearing in mind that suppliers need hedging to provide fixed price contracts to customers. It is not feasible to offer variable contracts to many customers, particularly domestic customers.
4.	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?
	Endesa Ireland considers that Directed Contracts have the necessary benefit of ensuring contracts are made available to the market with an independent price-setting mechanism. In order for Directed Contracts to be an effective market power mitigation measure, it is imperative that the price-setting mechanism continues to be unbiased and independent. If prices were set through an auction mechanism, for instance, the incumbents could have a direct and material impact on outcome prices. Endesa Ireland proposes that suppliers that are part of vertically integrated companies' eligibility for DCs should be based only on the portion of projected demand that is not able to be hedged internally by their own generation. Where that generation is located in another jurisdiction, the demand should be reduced by the annual interconnector capacity held by the vertically-integrated company. Endesa Ireland also proposes that provision must be made for new entrants to the market. A new entrant's eligibility for DCs should be based on projected market share. If these projections do not materialise as of the start of the tariff year, the DCs would be reoffered to the market. Otherwise, the current process could be seen as a barrier to entry. Endesa Ireland considers that in assessing market share metered generation, rather than installed capacity, should be measured. Endesa Ireland would like to see a short term contracts market develop, which would

	facilitate customer switching and more efficient interconnector trading. Currently DCs and NDCs are predominantly offered over a short window, once a year. This makes it difficult for market participants to refine their within-year position; a short-term contracts market with small clip size would help to address this issue. Endesa Ireland would specifically like to see auctions for CfDs aligned with EFA trading blocks on a monthly and quarterly basis so as to enable hedging for interconnector traders, thereby promoting trade across the interconnector. Endesa Ireland considers that the RAs should consult with participants on their preferred shape for DC offerings. Endesa Ireland considers that the impact of the current CfD credit cover arrangements on liquidity in the contracts market should also be examined by the RAs. The credit cover requirement is too high and ultimately imposes additional costs on customers. Endesa Ireland suggests that the Minister for Finance be approached to revise the requirement for ESB to a level similar to that required by Bord Gáis. Endesa Ireland is neutral as to whether HHI or RSI is used in determining DC volumes.
5.	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?
	Endesa Ireland believes that these measures have a huge impact on generators as ESB reintegration would mean that it has a reduced motivation to become a counterparty to a CfD as it has the benefit of internal hedging. Endesa Ireland proposes that the price of the CfDs to be offered by ESB should be approved by the RAs. Otherwise, these contracts could be priced out of the market and would not be of value to participants. It is Endesa Ireland's view that the EPO should not have been removed as any sensible commercial operator would seek best value in its purchases.
6.	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?
	Endesa Ireland believes that these measures have a huge impact on generators as ESB reintegration would mean that it has a reduced motivation to become a counterparty to a CfD as it has the benefit of internal hedging. Endesa Ireland proposes that ESB be required to enter, rather than just offer, CfDs to a certain proportion of its supply and generation market share, with the price approved by the RAs. It is Endesa Ireland's view that the EPO should not be removed as any sensible commercial operator would seek best value in its purchases in any event. In these circumstances Endesa Ireland considers that the maintenance of the EPO should not be burdensome on ESB but would act as a safeguard for the Irish customer.
7.	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?
	Liquidity The integration of ESB's supply and generation business could substantially reduce the number of contracts and desired mix of products available to independent players, and have a negative impact in the development of retail competition. Endesa Ireland would suggest that if the RAs were to allow further integration, appropriate regulatory measures will need to be put in place to maintain some liquidity in the contracts market. The RAs should be particularly cognisant of the problems in the UK in this regard and of the active regulatory monitoring role adopted by Ofgem and the regulatory interventions under consideration.[1] This could be mitigated by requiring a percentage of ESB PG and ESB CS contracts to be sold to/purchased from independents. As mentioned in point 6 above, ESB should be required to enter into CfDs to a certain percentage of its supply and generation market share, the price to be approved by the CER for NDCs. Endesa Ireland considers that the voluntary liquidity proposal from ESB is not sufficient and proposes that the CER must have the power to direct ESB in this regard and take enforcement action should the requirements not be met. The move to an all-island retail market would improve contract liquidity, as would a move to a regional market. Endesa Ireland would encourage the RAs to progress these issues and would encourage the RAs to set out a framework for regional integration to provide signals to help initiate the development of a regional contracts market. **MMU** Endesa Ireland proposes that if ESB is to be reintegrated that its offers should be reviewed ex ante by the MMU and if any changes are made to bids these should be approved by the MMU prior to implementation. Endesa Ireland does not consider that it is necessary to impose stricter bidding principles, but if any changes are to be made these should be signalled well in advance of implementation. **Information** Endesa Ireland considers that DCs should be calculated using a published formula and workings for supplier eligibility. Endesa Ireland does not believe that it is necessary to provide additional information on outages to the market. Endesa Ireland believes that an integrated ESB has an unfair advantage in that it has historic data for the large majority of electricity customers on the island, giving it a significant advantage in developing offers to attract or maintain these customers.
8.	Would further divestment by ESB encourage deeper competition in the wholesale market?

[1] See Ofgem's *GB wholesale electricity market liquidity: summer 2010 assessment,* Ref: 95/10, 29 July 2010. http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/Documents1/GB%20wholesale%20electricity%20market%20liquidity%20-%20summer%202010%20assessment.pdf

	Endesa Ireland considers that ESB should be fully privatised but recognises that at this point in time, due to wider economic factors, the assets would not realise their full value. Endesa Ireland considers that further divestment of ESB assets to private independent companies would encourage deeper competition by introducing further competition. Endesa Ireland believes that the sale of ESB assets to another semi-state company would not encourage real competition. Similarly, the idea of splitting ESB into two independent vertically integrated companies would not enhance real competition.
9.	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?
	The incentives on generators and suppliers to offer and purchase contracts are to minimise their exposure to risk, as outlined in response 3 above. Endesa Ireland does not agree with requiring all generators to offer contracts and/or to become market makers. Generators and suppliers will make offers as they see fit to hedge their respective positions. If they are to be required by the RAs to offer contracts or become market makers they should be free to choose their prices, although this could allow generators to offer high and unattractive prices. If the RAs are to set the prices then there should be a mechanism whereby generators are entitled to recover any losses they may incur as a result of mandatory contracts. Endesa Ireland considers that the current CfD credit cover arrangements may act as an impediment to trading.
10.	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?
	Endesa Ireland is not in favour of creating a minimum specification market maker obligation.
11.	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?
	See response to question 8 above.
12.	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?
	Endesa Ireland would query whether, if adopted, this liquidity proposal would be binding and by what means. Endesa Ireland considers that this provision should be binding and enforceable (perhaps by licence condition) if it is to be relied upon in reaching a decision to allow reintegration. Endesa Ireland is not satisfied with the provisions in the liquidity proposal which provide for the sunsetting of the liquidity proposal. Endesa Ireland would propose that when the thresholds listed in the ESB proposal are met the RAs should review whether the requirements should be stood down, and should consult on that issue. This should be stipulated in whatever mechanism makes the liquidity provisions binding on ESB group. Endesa Ireland considers that the quantum of contracts to be offered by ESB Generation and bought by ESB Retail should be based on ESB group's (not ESB PG's or ESB CS's), combined share of metered generation / customer demand, as opposed to installed capacity, or demand.

	As mentioned in response 6 above, Endesa Ireland considers that CER must approve the prices of the CfDs offered by ESB, to ensure that they are appropriately priced. Otherwise, these contracts will be of no benefit to the market. Endesa Ireland recommends a requirement for the inclusion of products based on EFA blocks, as mentioned in the ESB liquidity proposal, with the price offering to be approved by the RAs.
13.	Will increased wind penetration affect demand for contracts and the need for market liquidity?
	Endesa Ireland considers that increased wind penetration will increase the need for short term/spot contracts in the longer term. Endesa Ireland considers that in CEPA's analysis assumptions for wind penetration are higher than they should be.

Endesa Ireland is concerned by the uncertainty over whether PSO CfDs will be offered from 2011 and would ask the CER to bring clarity to this issue as soon as possible.

Endesa Ireland understands that the legal question over PSO CfDs may be the lack of statutory basis authorising the downside risk to be borne by the Irish customer. Endesa Ireland would suggest in this case that the PSO CfDs should be constructed as purely financial contracts, with a reasonable risk premium priced into the contracts.

Endesa Ireland would argue that the overall volume of CfDs should not decrease if PSO CfDs are no longer to be offered. Removal of these contracts would seriously reduce liquidity in the contracts market. Endesa Ireland considers that the volumes of CfDs which ESB propose to offer under its liquidity proposal should be amended by reference to the PSO CfD contracts to ensure that the total volume of CfDs on offer to the market is unchanged.

Please don't hesitate to contact me should you wish to discuss any aspects of this response.

Regards,

D de Powers

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