NIE Energy Limited
Power Procurement Business (PPB)

SEM Market Power and Liquidity

Consultation Paper

Response by NIE Energy (PPB)

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Power Procurement Business

Introduction

NIE Energy – Power Procurement Business ("PPB") welcomes the opportunity to respond to the consultation by the Regulatory Authorities on SEM Market Power and Liquidity. PPB has answered each of the questions set out in the consultation paper.

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

PPB believe that the existing Market Power Mitigation Strategy has been effective since the implementation of the SEM market, however we welcome the review of the Strategy in light of: an increase in wind capacity and interconnection; merger and acquisition activity; and changes in European and Domestic Legislation.

Bidding Code of Practice

The Bidding Code of Practice, whereby generators are required to bid at Short Run Marginal Cost (SRMC) provides a very good mechanism for managing the risk of market power as it provides transparency in price formation and limits the ability for a market participant to exert market power.

Market Monitoring Unit

In order to increase the effectiveness of the market monitoring unit it would be helpful if queries which have been raised are made publicly available. This would alert all market participants to potential bidding practices which may have material implications for other market participants.

Directed Contracts

The Bidding Code of Practice and the Market Monitoring Unit provide the key elements of the Market Power Mitigation Strategy. The weakness of the Directed Contract process is that the modelling is completed up to 18 months ahead of the actual trading day. Forecast and actual outturn scheduled /dispatched volumes will be very different and will become increasingly less accurate due to the additional wind generation and inter-connector capacity being commissioned. The debate between the use of HHI or RSI therefore becomes overshadowed by some other more material factors which will affect the ability of generators to exert market power in the spot market, such as changes in: relativity of gas and coal prices; availability of capacity; and volume of wind generation. Unless the Direct Contract Process becomes more dynamic then increasing reliance will need to be placed on other components of the Market Power Mitigation Strategy.

CEMA in their analysis of contract liquidity have compared ESTEM prices with CFD Strike Prices. This is inappropriate due to the fact that the pricing formulae ESTSEM is an approximation of SEM prices derived from assumption made up to 18 moths prior to the trading day. However when Market Participants are trading contracts for differences they will revise underlying market assumptions, such as plant availability, to ensure price forecasting is as accurate as possible. In addition the ESTSEM formula does not include a risk premium which buyers are willing to pay for price certainty and sellers require to take cognisance of other risks.

The main benefits of the Directed Contracts are: (1) certainty that a certain volume of hedging contracts will be made to the market and (2) a reference price for margining which is used in the absence of a forward curve a pricing source until such time as another forward price reference can be agreed between the counter-parties.

Ring Fencing

PPB believe that the existing ring fencing arrangements are effective. It is however important that these arrangements are kept under constant review by the regulators to take cognisance of investment and merger and acquisition activities. The review should include an entity's ability to abuse market power throughout the supply chain. For example ownership of gas or electricity infrastructure.

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

The new inter-connector will have the capability of improving competition. However the opportunities for arbitrage between the markets will be driven by underlying market fundamentals such as: capacity margins in each jurisdiction; and factors such as fiscal policies in the different jurisdiction (i.e. carbon taxes/ levies).

The regulator will also need to consider including inter-connector capacity in their modelling of market power (i.e. for the purposes of HHI calculations).

There is also a requirement for greater transparency in the governance process relating to market constraints especially with increasing levels of wind generation and inter-connector capacity. Robust long-term solutions are necessary to manage constraint related market power.

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.

The financial risk to market participants arises from uncertainties with respect to both price and volume. There is therefore a demand from market participants for hedging products in order to manage their exposure to market price risk, to manage their cash-flows, and to lock in gross margins. Generators in the SEM primarily use two hedging strategies: (1) a static hedging strategy using financial derivatives (2) Vertical integration between suppliers and generators constitutes an organisational hedge. Generators use a static hedging strategy due to illiquidity in the CfD Market. Volume uncertainty cannot be perfectly hedged by using financial derivatives, as there are no simple market instruments that would enable hedging of either total cost or volume risk. It is recognised that a lack of liquidity in the derivatives market makes hedging and risk management in SEM difficult. For this reason most market participants rely on static hedging strategies i.e. once the hedge is created it is not changed. Generators will be reluctant to put themselves in a position in which they may become over hedged unless they can rely on a liquid secondary market to trade out of a position. With increasing levels of wind capacity and an increase in customer switching between suppliers volume risk for market participants is going to increase.

For a supplier the use of fuel markets as a proxy for their SEM exposure introduces basis risk as there is not a perfect correlation between gas and SMP. There are also accountancy issues for entities which use financial derivatives indexed to commodities which they do not have an underlying physical position. European financial regulators are reviewing this area and in particular are considering applying different obligations for entities which cannot rely on hedging accounting.

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 volumes.

The main issue for the contracts market is maintaining and improving the total volume of contracts sold in the market. The maintenance of the existing volume of contracts offered to the market is important for suppliers to be able to maintain the same level of price risk management. Market participants are unlikely to implement a dynamic hedging strategy until the total volume traded in the contracts market is greater than 100% of the physical market.

Directed Contracts are likely to become increasingly ineffective in their ability to prevent market power unless the Directed Contract process is more performed more regularly and closer to the Trading Day. However a more regular Directed Contract process could have a material detrimental impact on the volume of Non Directed Contracts offered.

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 contracts markets? If you consider that it does, are there any replacement conditions required in the SEM and what should they be?

The removal of ring-fencing by ESBCS and ESBIE will increase the concentration of participants in the contracts market and a detrimental affect on market power in the contracts market. For example if a large number of customers where to switch to ESB from a third party supply company it is likely that ESB may be the only counter-party willing to buy the volume of financial derivative relating to the

customers who have switched. ESB could exert market power and corner the third party supply company.

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 contract market? If so, what replacement would you recommend for the SEM? Would the removal of the EPO from NIEES for customers below 150MWh per annum in NI have a similar impact – and if so, what replacement would you recommend.

Relative to other factors the removal of the economic purchasing obligation is unlikely to materially effect competition and liquidity in the SEM.

7 What if any, implications for competition / end customer do you see arising from ESB's proposed re-integration:

a. **Horizontally;**
b. **Vertically;**
c. **Horizontally & Vertically**

In each of the cases above the effect on competition and the end customer is going to be negative.

Horizontal integration of the Generation and Supply Businesses will result in fewer participants in the contracts market. A key feature of a liquid market is that it has a large number of buyers and sellers willing to transact at all times, providing high levels of secondary trading and limited risk of being cornered by another market participant. A reduction of participants in the contracts market will impact market

confidence and increase the barriers to entry in the contracts market. This in turn will act as a disincentive to invest in the SEM.

The paper focuses on market power in the physical market, however it is also important to consider market power in the contracts market, which is subject to the Market Abuse Directive. The European Commission is reviewing how participants in the wholesale gas and electricity markets cannot use inside information to benefit from their transactions, or manipulate the market and wholesale electricity and gas prices. This includes the manipulation of power prices by withholding or temporarily withdrawing capacity from the market. Companies in the electricity sector may find themselves subject to the MAD regime, which will raise additional market abuse and disclosure issues that will need to be addressed. Horizontal integration of the Generation Business will increase information asymmetry in the contracts market as the ESB Generation Business will have a greater insight into the future availability of a greater proportion of the installed generation capacity in the SEM.

Vertical integration will reduce the volume of contracts made available to the market.

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

Further divestment by ESB could play a very important role in encouraging competition. It is however important that divestment of plant is representative of all categories of plant in the ESB portfolio. For example base-load, mid merit, and peaking generating units must all be considered.

9 What are the current incentives on generators and suppliers to offer and purchase contracts? Are there any impediments to trading contracts?

Whilst traditional economic theory supports maximization of expected profits regardless to the variability of reported earnings there has been a growing volume of academic literature supporting the theoretical justification for corporate risk management and the value added by managing the volatility of financial performance. Financial hedging has traditionally been regarded as not being able to create or destroy value. CfDs are however regarded as a crucial element of the SEM market, enabling participants to effectively manage their market risk and enable new entrants to gain confidence in forward pricing, which otherwise would be a major barrier to entry. The avoidance of financial distress is a key consideration and is generally now regarded as providing value to a business. Therefore the incentive for Suppliers to purchase contracts is to enable them to manage their price risk and offer fixed tariffs to their customers. The incentive for Generators to offer contracts is to lock in their gross margins and to manage their cash flows.

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

PPB do not believe that major changes should be made to the types of products sold in the market. Whilst increasing the number of products may help participants to more closely match their supply/demand profile there is a risk that the more types of products which are introduced there will be a risk to overall liquidity. There is however a need to establish a market for prompt products which are traded, for example: week ahead and week ahead.

Companies should be encouraged to use the MTF to trade contracts as this will promote transparency and price formation in the contracts market. Bi-lateral trades completed outside the MTF arrangements will reduce market transparency and the ability for the market to establish a reliable forward curve. The establishment of credible and robust reference prices must be a key objective for the wholesale market. The timely and accurate publication of traded prices is necessary improving transparency and price discovery. It is unlikely that the Regulators could direct companies to become market makers as participants performing this role are generally subject to more stringent financial regulations, such as a requirement to become FSA authorised and to satisfy capital adequacy requirements.

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?

PPB would agree that it would be inappropriate to allow the vertical integration of the ESB Group. However we would not agree that the risks of allowing ESB generating companies to integrate is small. The increase in market power in the contracts market is a very important consideration and until more participants enter the contracts market, trading a material volume in the secondary market, then horizontal integration should not be allowed. Information asymmetry will

also be a major concern if horizontal integration is allowed to proceed as transparent price formation will be difficult to achieve.

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

Whilst the volume proposal is welcome there are a number of issues with the proposal.

The major issue is that the proposal will not deal with the increase in market power in the contracts market which will constrain the development of the contracts market which has been struggling to improve in liquidity. Positive steps have been made recently to try to improve liquidity in the contracts market, for example, increasing transparency by trading on an MTF and the publication of 2 year outage plans to address information asymmetry concerns. However the integration of ESB will have serious detrimental. If another market participant is required to trade because it has a long position, the increase in the market power of ESB places other market participants in greater risk of being cornered in the contracts market.

A second issue with the proposal is in relation to reserve price setting- especially if these are set at a price higher than a fair market price and no contracts are actually sold– it could be deemed that they have satisfied their volume commitment by offering contracts to market.

A third issue concerns the verification of the volumes forecast by ESB and whether or not these volumes will be reviewed as underlying assumptions changes.

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

With an increase in wind penetration the volume of contracts is likely to reduce considerably due to the volume risks which cannot be managed by conventional thermal generators. Generators are likely to reduce their hedging levels in their static hedging strategy in order to manage the volume risk associated with the variability of wind generation.