Response to Consultation on

SEM Market Power & Liquidity

(SEM/10/084)

22 March 2011

Introduction

Airtricity welcomes the opportunity to formally comment on this really crucial subject. We also thank the RAs for granting us the opportunity to present our views at the workshop organised to discuss this consultation. In the subsequent paragraphs we present our primary view on this matter. In the Appendix following we respond to the specific questions asked by the consultation paper.

An Operational Mechanism A Precursor to ESB Reintegration Request

ESB's liquidity proposal is exactly that – a proposal. Until is it made operational and demonstrably shown to be productively utilised, any views on whether it will assist in contract liquidity and facilitate competition will be mere postulations. Allowing ESB to reintegrate, particularly vertically, before *actual* (not planned, not intended) implementation of their liquidity proposals, letting that resulting mechanism operate for at least two cycles, and then conducting a review of the operational history, would effectively be putting the cart before the horse.

In theory the liquidity proposals by ESB are a good and welcome development. In practice however there are many elements of the liquidity proposals which may require operational experience to get right. These would include the pricing mechanism, the products available, the granularity, ability to trade on contracts. **Hence rather than offer the liquidity proposal as a 'trade' against being allowed to reintegrate, the proposal should be set into a 'roadmap' wherein its implementation and successful operation should be precursor to any request for reintegration.** A review at the end of a pre-determined monitoring period, say two years, would be in a much better position to infer the effects on liquidity and competition and make recommendations, one of which may well be a mandate on ESB to maintain such mechanism in place until a specific event, perhaps until ESB market share drops to 30% or until a Regional Electricity Market encompassing SEM becomes operational.

Only fully entrenched competitive pressures can practically and effectively check market power. Mere proposals, badly implemented proposals will not do. **A demonstrably functioning mechanism is essential.**

The liquidity situation is further complicated by the indication from the RAs that the PSO-backed contracts may no longer be offered to the market. While we fervently hope that this is not the case, if however it is clarified to be the legal position, then the need to promptly adopt and implement a more productive contracts trading arrangement as proposed by ESBPG becomes even more pressing.

To discuss the document contact:

Emeka Chukwureh
emeka.chukwureh@airtricity.com

APPENDIX

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

Yes.

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?

The East West Interconnector (EWIC) will not on its own do much for greater competition. While the increased capacity will be useful, of greater importance will be the access rules implemented, as well as the pending modifications to the SEM trading arrangements. Beyond those the current Energy Market Reforms being conducted in GB will also have effect on the level of competition to be expected by the operation of the new interconnector.

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 gross mandatory purchasing requirement for suppliers in the SEM implies that they are fully exposed to wholesale electricity spot prices. The need for procurement hedging arises as the wholesale prices have to be matched against supply contracts effective in the retail market, where less volatile, multi-period products such as annual supply contracts are required.

Alternative hedging options include use of interconnector capacity and to this end the additional capacity of the EWIC will be welcome, as well as fuel markets hedging. However fuel markets hedging, otherwise known as ‘dirty hedging’, involves significant bases risks such as the spreads between the fuel commodities, carbon and electricity and the trading granularity mismatches of the fuel commodities and electricity.

Synthetic hedges are only approximations of hedges that can be obtained in the primary asset class under consideration – SEM prices. The farther away from the primary asset that those synthetic hedges are removed, on the basis of fuel, jurisdiction, or market, the greater the risks introduced, and hence progressively nullifying the rationale for the hedges in the first instance.

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?

ESBPG has issued liquidity proposals to industry underpinning their request for reintegration. These proposed trading arrangements involve greater product shapes and durations, more frequent auctions, smaller clip sizes, early indication of products and volumes and facilitation of brokerage: in essence what a well-functioning DC process should look like. Given that ESBPG administers the DC process, it would be straightforward to adopt their proposals into that process. Indeed we would strongly recommend that.

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?

As Supply Units do not bid in SEM, we do not view the removal of the EPOs as having significant negative impacts on the SEM spot market. However, the harmonisation of the supply volumes of the respective two supply entities, gives them greater leverage in the contracts markets, particularly the NDC market. Viewing outcomes from a corporate group perspective, a supply entity could always over-bid in the NDC process in the first instance to corner available volumes, but also to raise expectations in that market and thus cause subsequent uptrends in price bids. It could engage in such behaviour as long as any benefits ultimately transfer to its affiliated generation entity.

Given that potential, we would reiterate the frequent calls to strengthen the MMU by making it much more visible and proactive. Equally, to the extent possible, bearing in mind that the NDC process is more a commercially-directed mechanism, it may be necessary to place restrictions on the quantities that the combined ESBCS and ESBIE, as well as NIEES can procure at those auctions.

However we must also point out that there is a peer-policing ability by the mere fact that vertical separation exists between the supply and generation arms of the incumbents. If any 'transfer' of benefits is occurring, it is easier identified so long as the supply and generation entities keep separate books.

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?

See response to Q.5 above.

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?

Any issues with horizontal integration have largely to do with the potential situation we have identified in response to Q.5 above.

With vertical integration, what is a potential situation becomes implicitly buried deep within the internal structure of the combined entity. Given ESB's current and foreseen continuing market dominance, competition can be squeezed at will at either end (supply or generation) by shifting value to the opposite entity. Thus vertical integration may be disastrous for the fledgling competition in SEM.

While it is true that competition seems to have taken hold in SEM, it has to be recognised that such competition cannot yet stand on its own. Such competition as exists does not yet arise from a 'battle amongst equals' but from a managed framework which limits the exercise of resident market power. Allowing ESB to vertically reintegrate at this time, given the still very weak competitive pressures in SEM, will remove the protection under which the observed competition is operating.

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

Further divestment by ESB would be strongly welcome. However the success of such an approach would undoubtedly depend on the quality of assets being divested. There would be no use in divesting assets that are either at the end of their lives or are seriously depreciated. As demonstrated in our presentation at the workshop organised by the RAs on this matter, the divestment process undertaken under the CER-ESB Asset Strategy has not encouraged any effective competition in SEM. On the contrary it has actually increased ESB's market share on running basis.

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?

Given the small size of the Irish electricity system, the relative ‘blockiness’ of available generation, the lack of interconnectivity, the dominance of gas generation, the near structural price stasis between gas and the other fossil fuels, the tight linking between SEM spot prices and gas spot prices it is difficult to see any incentive on generators to offer contracts. On that basis, it may appear an attractive option to place some form of mandate on all generation. However we cannot endorse this idea, as it simply introduces another ongoing regulatory mechanism into the mix. It will be more desirable to employ one-off measures that encourage deeper competition, such as the divestment option mooted in Q.8 above. In addition, it is much more likely that greater interconnectivity and more flexible trading arrangements across such new connections will increase the pool of potential traders, with more diverse portfolio holdings and hence enable commercially-driven contracting.

Having said all that however, it may be worth exploring in further detail an expansion of the market power mitigation strategy in the mandating of dominant market participants to become market makers. On the basis that the strategy is already operational and that even though it is a regulatory mechanism it may be employed to facilitate commercially competitive transactions, it will definitely be worth examining. The proposal that ESBPG has developed to date may be an excellent springboard for this.

For suppliers, the need to match multi-period retail contracts to volatile spot prices and the relative short generation positions essentially necessitate seeking hedge contracts. This need is met variously by contracting for physical power from de-minimis generation and from the use of the interconnector with Scotland. Irrespective of these the availability and ease of access to financial contracts will be invaluable for their flexibility and malleability.

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?

The question would be better addressed as part of a focussed workstream on establishing a mandated contract trading mechanism. However it is important that as much flexibility and granularity as is practical be included in developing products as well as their sizes.

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?

Yes, in every respect.

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?

ESB's liquidity proposal is exactly that – a proposal. Unless is it operational and demonstrably being utilised, any views on whether it will assist in contract liquidity will be mere postulations. Allowing ESB to reintegrate, particularly vertically, before *actual* (not planned) implementation of their liquidity proposals, letting that resulting mechanism operate for at least two cycles, and then conducting a review of the operational history, would effectively be putting the cart before the horse.

In theory the liquidity proposals by ESB are a good and welcome development. In an aside, as we have said earlier, perhaps this should be adopted for the DC process. In practice however there are many elements of the liquidity proposals which may require operational experience to get right. These would include the pricing mechanism, the products available, the granularity, ability to trade on contracts. **Hence rather than offer the liquidity proposal as a 'trade' against being allowed to reintegrate, the proposal should be set into a 'roadmap' wherein its implementation and successful operation should be precursor to any request for reintegration.** A review at the end of a pre-determined monitoring period, say two years, would be in a much better position to infer the effect on competition and make recommendations, one of which may well be a mandate on ESB to maintain such mechanisms in place until a specific event, perhaps until ESB market share drops to 30% or until a Regional Electricity Market encompassing SEM becomes operational.

As we have tried to emphasise throughout our response, it is only entrenched competitive pressures that can effectively check market power. Mere proposals, badly implemented proposals will not do. **A demonstrably functioning mechanism is essential.**

The liquidity situation is further complicated by the indication from the RAs that the PSO-backed contracts may no longer be offered to the market. While we fervently hope that this is not the case, if however it is clarified to be the legal position, then the need to promptly adopt and implement a more productive contracts trading arrangement as proposed by ESBPG becomes even more pressing.

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

Most definitely so. Increased wind penetration is likely to have a more volatile effect on wholesale electricity prices, as well as demand (arising from demand response). All that volatility is much more likely to further increase the need for hedging contracts and market liquidity.