# SEM Market Power & Liquidity

## A SEM Committee Decision Paper

**1st February 2012**

**SEM-12-002**

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# EXECUTIVE SUMMARY

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## 1. Background

In 2010 the Regulatory Authorities (RAs), on behalf of the SEM Committee, commenced a review of market power and contract liquidity in the SEM. The overall aim of this project was to identify practical ways in which the RAs can further promote competition in the SEM by reducing/mitigating market power and/or improving contract liquidity over the course of the next 10 years. In this context the project has also examined the various components of ESB's proposed re-integration of its businesses.

The RAs appointed consultants, CEPA, to undertake an independent review of market power and liquidity in the SEM, including ESB's integration proposals. CEPA's report, along with an RA cover paper, was published for public consultation from 16th December 2010 through to 22nd March 2011. The SEM Committee then considered the CEPA paper and the public responses to it. It also considered ESB's new "partial vertical integration proposal" received in June 2011 and CEPA's subsequent report on that proposal.

On 25th November 2011 the SEM Committee published a draft decision (SEM-11-089), along with a report from CEPA, for final public comment. Taking account of its duties and objectives, and comments received to the draft decision, the SEM Committee now publishes this final decision on the issues raised as part of the market power and liquidity project. Specifically this paper:

- Summarises the comments received to the draft decision - please see section 2. Generally there was a favourable response to the draft decision's proposals; and,

- Provides the SEM Committee's decision on market power and liquidity, specifically in relation to the market power mitigation measures, contract liquidity and the issue of ESB's requests to integrate its businesses. This is detailed in section 3, with a summary provided below.

## 2. Policy Decisions

There are no significant policy changes from the proposals contained in the draft decision. The key SEM Committee decisions on market power and liquidity are summarised below.

*BCoP, MMU and DCs*

The SEM spot market at present is quite highly concentrated. However, the SEM Committee is satisfied that there has been no significant market power exercised in the spot market to date due to the relevant market power mitigation measures in place. The BCoP, MMU and DCs have helped ensure that generator bids are at competitive SRMC levels, resulting in SEM wholesale prices that are efficient and providing the correct market signals. CEPA also believe that these measures have played a strong role in mitigating market power.

Looking forward, CEPA's spot market modelling analysis for 2015/'20 indicated that while ESB's market power would not be at levels of concern *on average*, there would still be certain hours/scenarios when the RSI is below 1.2, the threshold that typically suggests market power potential. Therefore CEPA suggested that the RAs maintain a robust market power mitigation strategy for the foreseeable future.

In view of this and the strong support shown in the responses to the public consultations, the SEM Committee will maintain BCoP/MMU and DCs as market power mitigants for the foreseeable future. If the spot market becomes significantly less concentrated in the future, the Committee will then review these market power mitigation measures. Any changes would be subject to public consultation.

*REMIT*

In relation to the prohibition and monitoring of market power abuse, the RAs note that the "European Regulation on Energy Market Integrity and Transparency" (REMIT) was adopted as European law on 28th December 2011. REMIT is expected to provide an extra level of market power abuse protection for SEM, with new market monitoring to be carried out by ACER in addition to that carried out by the MMU (see section 3 of the paper for more information).

The RAs will be hosting a public workshop with interested parties to discuss REMIT and its potential implications for SEM and market participants – the workshop is planned for March and details will be provided on the RAs' website (www.allislandproject.org) shortly.

*ESB Vertical Ring-Fencing*

In line with the draft decision, the SEM Committee will not allow either the ESB full vertical integration or "partial vertical integration" options for now, for the reasons outlined below.

- The spot market is quite highly concentrated using the internationally applied HHI measure;

- Contract market power potential would be more significant than the status quo. The exercise of contract market power by ESB could disruptive to other suppliers and retail competition, as well as to the long-run cost to the consumer. There could also be informational advantages which would benefit Electric Ireland with either vertical integration option, which could have a negative impact on competition in both the wholesale and retail markets; and,

- CEPA are of the view that full vertical integration is unfavourable as it could damage competition. While it is acknowledged that there could be more RA "contract regulation" under ESB's "partial vertical integration" option, along with a similar level of liquidity to present levels, CEPA are of the view that this option is unfavourable as doing so would replace a structural remedy with a likely less efficient and/or effective regulatory remedy.

All bar one respondent that commented to the draft decision agreed with this SEM Committee position.

The SEM Committee would, however, separately consider any proposals for ESB vertical integration in the context of a material change to market power in the SEM. An example of a material change would be a significant reduction in ESB's generation plant portfolio. Any proposed changes to vertical ring-fencing would be subject to separate public consultation.

*ESB Horizontal Integration*

The following considerations make the horizontal integration of ESB generation more acceptable:

- CEPA states in the December 2010 paper that, with BCoP in place, *"the operational horizontal separation of ESB seems to have little value in promoting competition, whilst adding some cost to ESB, and thus an operational integration should be considered".* There would not be the higher market power risks associated with full vertical integration;

- ESB could make generation cost savings from horizontal integration, with low market power risks for the end customer. Any efficiency gain would be welcome, especially in the current economic climate; and,

- Horizontal integration would significantly increase the quantity of DCs available to eligible market participants. Using the current methodology, DCs would rise noticeably from the current 1.66 TWh level, probably doubling or more to circa 4 TWh, though the exact figure would depend on modelled fuel prices, etc. The increase in DC volumes will likely increase the proportion of total contracts made available that are regulated by the RAs, reducing contract market power.

In light of these considerations and the generally favourable comments to this proposal in the draft decision, the SEM Committee will allow the horizontal integration of ESB generation units, i.e. of ESB PG and ESBI. Horizontal integration will become fully effective from 1st October 2012; licence changes will be made as needed beforehand.

*Liquidity*

The SEM Committee notes the recent developments in contract liquidity, discussed in more detail in the draft decision:

- PSO-related CfDs will continue, as confirmed by the RAs in April 2011, and regular NDC short-term products are being offered; and,

- A new Tullet Prebon "Over the Counter" (TP OTC) trading facility has commenced and should help to assist liquidity, by allowing for suppliers and generators to interact more with respect to NDC price and quantities, assisting in price discovery.

The SEM Committee doesn't consider it appropriate at this time to establish a market maker facility in which a market participant (say ESB) would be required to continuously have a buy/sell facility for contracts at all times (e.g. via an exchange). Similarly the Committee will not proceed with an option of mandating contracts from generators at this time. There could be a significant cost to industry while the demand for such a continuous trading facility is unclear. The SEM Committee believes that, as per the draft decision, liquidity is generally best developed "organically" through industry/market initiatives. It is noted that respondents to the draft decision generally concurred with this view.

However, there may be a case for proceeding with such an approach in the future, in the context of the integration of SEM into European markets. This is because market-coupling with Europe could involve day-ahead CfDs. The RAs' Market Integration Project Team will lead this work and any initiatives in this area will be fully consulted on by the RAs at the appropriate time.

*DC Offerings*

No party that responded to the draft decision advocated reducing the 1,150 HHI threshold for DCs at present. The SEM Committee has decided that this threshold will continue for the moment.

That said, the SEM Committee will continue to actively monitor the spot and contracts markets for evidence of market power being exercised. If the SEM Committee becomes aware of any evidence of spot or contract market power being exercised by market participants, including the exercise of NDC market power or insufficient contract liquidity, the SEM Committee will take appropriate regulatory action to address the situation, including potentially lowering the HHI threshold for DCs. This would be subject to separate consultation at that time.

In February of this year the RAs will consult on the frequency of the DC offerings for 2012/13 (i.e. annual or more regular), in a similar manner to the regular process, before deciding on the matter.

# 1. Background

## 1.1. Introduction

Since 1st November 2007, the Northern Ireland Authority for Utility Regulation (or Utility Regulator) and the Commission for Energy Regulation (CER), together referred to as the Regulatory Authorities or RAs, have jointly regulated the all-island wholesale electricity market known as the Single Electricity Market (SEM), covering both Northern Ireland and the Republic of Ireland. The decision-making body which governs the SEM is the SEM Committee[1], consisting of the CER, the Utility Regulator as well as an independent member (who also has a deputy).

The SEM includes a centralised gross pool or spot market which, given its mandatory nature for generators (above 10 MW) and suppliers, is fully liquid. In this pool electricity is bought and sold through a market clearing mechanism, whereby generators bid in the Short Run Marginal Cost (SRMC) and receive the System Marginal Price (SMP) for each trading period. The SEM rules are set out in detail in the Trading and Settlement Code[2].

There are inherent features of the SEM design that serve to mitigate the exercise of market power from any one market participant. In addition, the RAs developed particular market power mitigation measures for SEM, as part of a "market power mitigation strategy". Related to this, to date there have been offerings of 2-way Contracts for Differences (CfDs), to enable generators and suppliers manage and hedge the wholesale price - i.e. SMP - risk inherent in the SEM. Liquidity in these contracts enhances the financial certainty, flexibility and innovation of participants in both the wholesale and retail markets.

An explanation of market power, the market power mitigation strategy/measures and contract liquidity in the SEM can be found in a previous RA paper, SEM-10-057, available at the following link.

http://www.allislandproject.org/GetAttachment.aspx?id=e83a335f-8366-416c-a6fe-96a0d54b1721

## 1.2 Scope of Project

In the 2nd quarter of 2010 the RAs, on behalf of the SEM Committee, commenced a review of market power and contract liquidity in the SEM. The overall aim of this project has been to identify practical ways in which the RAs can further promote competition in the SEM by reducing/mitigating market power and/or improving contract liquidity over the course of the next 10 years. This project included a review of the performance of the SEM market power mitigation measures in the context of experience to date and, looking forward, likely developments over the next 10 years which could alter market power. These developments include increased interconnection and new market participants (including, for example, wind generation).

[1] The SEM Committee is established in Ireland and Northern Ireland by virtue of Section 8A of the Electricity Regulation Act 1999 as inserted by Section 4 of the Electricity Regulation (Amendment) Act 2007, and Article 6 (1) of the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007 respectively.

[2] Please see http://www.allislandproject.org/en/trading_and_settlement_code.aspx

The project has also examined measures which might be necessary to mitigate any potential adverse effects on market power and/or liquidity resulting from the various components of ESB's proposed re-integration.

## 1.3 RAs' State of the Nation

In August 2010 the RAs published a "State of the Nation" paper (SEM-10-057) whose purpose was to:

- Inform market participants of the scope of the review project;

- Provide a factual overview of the design and operation of the SEM, in particular:

  (A) The market power mitigation strategy adopted to date by the RAs; and,
  (B) The operation of the market since the inception of the SEM, including levels of market power in the spot and forward contract markets, as well as forward contract liquidity; and,

- Seek any initial ideas from market participants on the policy issues being examined as part of this review project.

## 1.4 CEPA Paper

In July 2010 the RAs appointed independent consultants, CEPA, to assist the RAs by undertaking an independent review of market power and liquidity in SEM. Having taken on board the comments received to the RAs' "State of the Nation" paper as well as input from the RAs on factual matters and in relation to market modelling, CEPA undertook an independent review of market power, liquidity and ESB's integration/liquidity proposals. CEPA's report, along with an RA cover paper, was published for public consultation on 16th December 2010 – currently available at the following link:

http://www.allislandproject.org/en/market_current_consultations.aspx?article=682a98fe-9c18-4c73-8fa3-57e75d24d85e

To explain the CEPA paper and discuss industry views, the RAs held a public workshop in the CER office on 18th January 2011. In brief, the CEPA paper found the following:

- Modelling analysis indicates that, while ESB's RSI levels for 2015 and 2020 would *on average* not be at levels of concern from a market power perspective, there would still be some scenarios/hours where RSI levels are below 1.2, i.e. market power could still be exercised by ESB at certain times. This suggests the need for a market power mitigation strategy into the future.
- The BCoP, MMU and DCs provide substantial protection against the abuse of market power. Given the need for robust market monitoring and bidding principles, BCoP, MMU and DCs should continue for the foreseeable future as market power miitigants.
- The benefits of operational horizontal ring-fencing of ESB generation units are unlikely to outweigh the costs while robust market monitoring and bidding principles remain. It is unclear what additional risks of exploitation of market power horizontal ring-fencing addresses – hence "operational" horizontal integration of ESB generation should be considered.
- Vertical ring-fencing is an important component of measures to restrain market power. ESB's liquidity proposals would only mitigate a power that ESB does not currently hold. CEPA's assessment was that relying on "behavioural" and/or regulatory remedies (e.g. by enhancing the market power mitigation strategy) to allow vertical integration of

the ESB Group is unfavourable at this stage as doing so would remove a "structural" remedy.

- The following measures could help to improve contract liquidity:
  - Further interconnection / market coupling;
  - The enhancing of market information to help contract formation, e.g. outage planning;
  - A market-maker, especially for smaller suppliers, to help new entry;
  - The introduction of a mandatory liquidity provision mechanism from generators.

The deadline for comment to this consultation was extended to 22nd March 2011, primarily due to uncertainty regarding the legal basis for PSO-related CfDs, which has since been resolved through the publication of an RA paper in April confirming the availability of PSO-related CfDs (see draft decision).

## 1.5 Draft Decision

The SEM Committee then considered the CEPA paper and the responses to it, as well as a new "partial vertical integration proposal" from ESB received by the RAs in June 2011 and CEPA's subsequent review of that proposal. Following this the SEM Committee published a draft decision paper on 25th November 2011 (SEM-11-089). This paper is currently available at the link below, along with CEPA's report on ESB's "partial integration proposal".

http://www.allislandproject.org/en/market_current_consultations.aspx?article=682a98fe-9c18-4c73-8fa3-57e75d24d85e&mode=author

The purpose of this SEM Committee draft decision was to:

- Summarise the key comments received to the CEPA-related consultation paper which closed in March, and provide an RA response to these comments.

- Provide an update on developments relevant to the market power and liquidity, project, including in relation to contract liquidity and the new "partial vertical integration" proposal from ESB.

- Provide the SEM Committee's view regarding issues raised as part of this project, including in relation to the market power mitigation measures, contract liquidity and the issue of ESB's requests to integrate its businesses; and,

- Provide market participants with an opportunity to comment on the SEM Committee's view on project issues.

## 1.6 Purpose of this Decision Paper

Taking account of its general duties and objectives and comments received to the draft decision, the SEM Committee now published this final decision on the issues raised as part of the market power and liquidity project. Specifically this paper:

- Summarises the comments received to the draft decision - please see section 2;

- Provides the SEM Committee's final decision on market power and liquidity, specifically in relation to the market power mitigation measures, contract liquidity and the issue of ESB's requests to integrate its businesses - please see section 3.

# 2. Summary of Comments

## 2.1 Respondent Names

There were 8 responses to the SEM Committee's draft decision paper on market power and liquidity (SEM-11-089) as below, and they are published with this paper where they were not marked as confidential.

- Endesa Ireland
- NEA Ireland
- Power NI
- Airtricity
- Bord Gáis Energy
- ESB
- AES
- Energia

Taking account of these comments, section 3 of this paper provides specific SEM Committee policy decisions covering the areas of market power, contract liquidity and ESB integration.

## 2.2 Summary of Comments Received

This section summarises the key comments received by topic, followed by an RA response. Overall, there was a positive response to the proposals contained in the draft decision paper, as detailed below.

**Spot Market Power Mitigants - DCs, BCoP and MMU**

***Overall***

There was a broad welcome to the draft decision's proposed continuation of DCs, the BCoP and the MMU as spot market power mitigants for the foreseeable future, with Power NI, Airtricity, Bord Gáis Energy, AES, ESB and Energia referring to how they agree with this approach.

Following from the introduction of REMIT, NEAI would like to accept the RAs' invitation to meet to discuss initiatives in the contract liquidity (see later). Bord Gáis Energy similarly requested that the RAs consider hosting a workshop to discuss REMIT and its implications.

***Specific Comments***

Regarding the MMU, Airtricity stated that its full potential is not being exploited, and believes that the MMU should provide more analytical information to the market. Both Airtricity and Energia referred to a forthcoming decision on the MMU governance processes. Airtricity hopes this decision will enable the MMU to function more constructively, while Energia suggested it be published first as draft decision for consultation, given delays surrounding this issue.

In relation to the measure of market power for DCs, Energia expressed surprise that it remains based on HHI as it believes that RSI is generally accepted as superior, while ESB said it is indifferent but that HHI is probably simpler for DCs.

No party advocated reducing the 1,150 HHI threshold for DCs for spot market power reasons (which would increase DC volumes) for the moment. Indeed Airtricity welcomed the proposal to maintain the 1,150 HHI threshold and Energia stated that any change is without basis. ESB believes that the 1,150 DC threshold should be raised towards 1,500, as the RAs previously stated that the DC level should be the minimum to ensure a competitive market, and it is clear that 1,150 is a conservative level given market developments. ESB also expressed a concern that DCs can be seen as a means to resolve liquidity issues rather than as a market power mechanism, stating that the imposition of additional DCs above those required to bring ESB's market power to an acceptable level would be discriminatory (see later liquidity comments also).

***RA Response***

*In view of the effectiveness of the BCoP, MMU and DCs to date in the SEM, and given current and predicted SEM spot market power levels, the SEM Committee will maintain a robust market power mitigation strategy through these instruments for the foreseeable future. The SEM Committee would review these market power mitigation measures in the future if the spot market became significantly less concentrated.*

*In response to the comment regarding the MMU providing more analytical information, the MMU aims to deliver an MMU public report in the first half of 2012. The MMU also aims to publish a decision on the MMU Governance processes in Spring 2012. The MMU agrees to publish this as a draft decision for comment first.*

*DCs will remain based on HHI as it is an internationally recognised and respected measure of market power and there is no compelling reason to change it. The 1,150 HHI threshold for the provision of DCs is considered appropriate for now to reduce ESB's spot market power to acceptable levels – 1,150 provides for a relatively low level of market concentration, given the specific characteristics of the electricity spot market. In addition, as referred to in section 3, the horizontal integration of ESB is likely to result in a significant rise in DC volumes compared to the status quo, using the 1,150 threshold.*

*The RAs have recently met the NEAI to discuss liquidity developments and REMIT, including in relation to the OTC facility (see later), and are happy to meet any interested parties to discuss the matter. The RAs agree that a public workshop on REMIT would be useful and so will be hosting a public workshop with interested parties to discuss REMIT and its potential implications for SEM and market participants; the workshop is planned for March and details will be provided on the RAs' website ([www.allislandproject.org](www.allislandproject.org)) shortly.*

**ESB Vertical Ring-Fencing**

All bar one respondent that commented on the issue agreed with the SEM Committee's position of not allowing the vertical integration of ESB for now due to its potential negative impacts on the market/liquidity, including Power NI, Airtricity, Bord Gáis Energy, Energia and AES.

Bord Gáis Energy agreed with ESB's suggestion that a timescale for the removal of vertical ring-fencing should be provided for transparency/clarity, if the SEM Committee anticipates a revision of its position, with a detailed list of objective criteria/Roadmap for reintegration and any subsequent consultation including a detailed impact analysis. AES also stressed that any future review of this issue should be fully consulted on.

In contrast, ESB was disappointed that vertical integration was not approved. It stated that it is the normal mode of operation of electricity companies and that it enables participants to achieve the lowest cost of operation with the most effective means of managing trading risk. It believes that vertically ring-fencing is an unnecessary burden for ESB given market developments, and full integration would enable ESB to reduce costs, which would further improve ESB's product offering and facilitate cost reduction for all electricity customers on the island.

ESB believes that that CEPA overlooked some key facets of ESB's "partial vertical integration" proposal that would resolve CEPA's concerns with integration. It suggests that there would be merit in engaging with CEPA and the RAs to address these concerns. ESB also requested that upon completion of horizontal integration (October 2012), the RAs re-engage with ESB to explore the customer benefits of vertical integration.

***RA Response***

*The RAs acknowledge that there is a cost for ESB associated with the vertical ring-fencing of its business units. However this cost must be balanced against the cost and risks to the customer, in terms of potential market power abuse and greater associated costs, of no ring-fencing being in place. Hence, similar to most respondents, the SEM Committee continues to be of the view that vertical integration of ESB would be damaging to the market and will not allow it at this time. The detailed reasons for this were provided in the draft decision and are also in section 3 of this paper.*

*The SEM Committee will not give a timescale for the removal of ring-fencing because it would depend on the circumstances, which would need to be considered at the time. This would include, for example, ESB's market share in SEM and the extent to which SEM is integrated into a neighbouring European market. If there were a material change to market power in the SEM, for example a significant divestment of some of ESB's generation plant portfolio leading to a reduction in its market power, the SEM Committee would re-visit proposals for vertical integration. Any proposed changes to vertical ring-fencing in this regard would involve a separate public consultation.*

**<u>ESB Horizontal Integration</u>**

Most respondents did not raise any objection to the horizontal integration of ESB generation, with Endesa, Airtricity and ESB specifically referring to how they had no objection. ESB mentioned that this will increase the level of DCs, which will provide cost benefits to all suppliers and through to end customers.

Energia was the only party unsupportive of the proposal, referring to it increasing reliance on the market mitigation measures, while not likely to increase overall contract liquidity levels. It also stated that more DCs may restrict the development of products in the market.

***RA Response***

*The SEM Committee continues to be of the view that there is a very low market power risk associated with allowing horizontal integration, given that the BCoP/MMU and DCs are in place. It could provide for some efficiency savings and will also significantly increase the quantity of DCs from present level, helping to reduce the contract market power potential (see section 3). The increase in DCs does not, however, have to restrict contract product development. Any party that meets the requirements can offer NDCs and, as stated in* *section 3, the RAs encourage the "organic development" of liquidity with cross-industry involvement, for example through the new OTC facility (see later).*

*In light of these considerations, the SEM Committee will allow the horizontal integration of ESB generation units, i.e. of ESB PG and ESBI. It is proposed that horizontal integration will become fully effective from 1st October 2012; licence changes will be made as needed beforehand.*

**Contract Liquidity**

NEAI, Airtricity, Energia and Bord Gáis Energy and AES welcomed the RAs suggestion to "take an organic approach" rather than mandating contract liquidity at this time. There was also a generally positive view of the new Over-the-Counter (OTC) brokered market for contract liquidity.

NEAI felt that an organic approach could allow further progress in contract liquidity, such as via the new OTC brokered, on which it has been working with ESB and Tullet Prebon. Airtricity believes that while the liquidity situation is not satisfactory, the new OTC can be developed over time. It said this area needs ongoing monitoring and perhaps reconsideration as new developments arise. Energia believes the OTC benefit is more in relation to its potential - significant improvements are needed before liquidity needs are fully addressed. AES welcomed the OTC market and will be working through the NEAI on the matter.

Power NI and Energia welcomed continuation of [Irish] PSO-related CfDs. Power NI stated that while market developments in this area are laudable, the impact of wind and cancellation of contracts in NI puts pressure on volumes, hence it urged the RAs to monitor this aspect of the market and be prepared to mandate volumes if liquidity does not materialise.

ESB welcomed the acknowledgement of recent developments in contract liquidity including PSO-related CfDs, regular NDC auctions and the new OTC trading facility, which ESB has been instrumental in facilitating. However it remains concerned that ESB is the only market participant selling contracts and that the RAs mistake ESB co-operation as market power. Furthermore, if it continues that ESB is the only player developing liquidity initiatives, then some direct intervention impacting all generators must be required. It would be helpful to confirm that if liquidity doesn't improve organically, ESB would not be required to resolve the matter with more DCs, in order to promote the involvement of all market participants in organic liquidly initiatives.

ESB would like the matter of contract market power to be explored and understood by the RAs and industry, while Energia suggested that proposals to address contract market power be included in the paper given that is a concern, even if ESB is ring-fenced.

Energia endorsed the intention to continue to monitor the market and address any falls in liquidity. Where this results from market power, they suggest that lowing the HHI is an appropriate response; if liquidity falls for other reasons, mandating NDCs or a market maker on ESB may be appropriate.

In relation to the increase in DCs from horizontal integration, ESB proposes constructively discussing the timing of such sale contracts with the RAs and market participants. Energia's view is that increased DCs from horizontal integration risks changing the balance of contracts offered and so a revision of DCs should be considered with more of a role in short-term and rolling products. On the other hand Airtricity believes that, given the continuation of

Irish PSO-related CfDs, a heavy dependence on DCs will not materialise and that DCs will continue to contribute to the overall contracts mix with PSO-related CfDs and NDCs.

***RA Response***

*The RAs continue to believe that contract liquidity should develop organically for now and welcomes the new Tullet Prebon "Over the Counter (OTC)" facility in this regard. As part of this organic development, the RAs would be keen to see this develop further, with industry participation among both sellers and buyers. This is a potentially significant addition to the provision of liquidity in the SEM, giving buyers and suppliers the opportunity to interact more in contract price/quantity formation.*

*Given that it is the biggest generating company in SEM, ESB does have a major role to play in the provision of contract liquidity. The recent liquidity developments (such as the OTC facility) which have occurred with major ESB participation are acknowledged and welcomed by the RAs. The RAs also agree that increased contract liquidity going forward is not the sole responsibility of ESB, but rather the entire market, and we encourage all market participants to engage on this issue.*

*Contract market power concerns were explained in the draft decision and are referred to in section 3. The RAs are planning to continue to monitor contract liquidity and if there is any evidence of liquidity levels falling due to contract market power being exercised, the SEM Committee reserves the right to take action, including the lowering of threshold for DCs (increasing DC volumes). This would be subject to separate public consultation at the time.*

*Separately, the RAs' Market Integration Project Team will shortly consider options which may involve a day-ahead market in SEM. If developed, this could facilitate more liquidity and assist with market integration. Any initiatives in this area will be fully consulted on by the RAs at the appropriate time.*

*Regarding the timing and form of DC products (currently annual offerings) that will be on offer from October 2012, the SEM Committee will issue a separate consultation on the matter in February as part of its regular determination of the DC process, and will decide on the matter separately as part of this process. This decision will take account of market participant responses, the desire to have a mixture of short, medium and long-term products available to the market (between DCs, NDCs and PSO-related CfDs), and the primary role of DCs as a market power mitigation measure.*

**<u>Other Comments</u>**

Energia welcomed the proposals in the draft decision, but criticised the 3-week nature of the consultation which it considered too short, stating that an 8 -12 week timeline would be more appropriate.

***RA Response***

*The market power and liquidity draft decision was published after a previous and extensive public consultation, when market participants had approximately 3 months to respond to the RAs, and during which a public workshop was also organised by the RAs. Hence there has been ample time for market participants to engage with the RAs on this project and to express their views.*

# 3. Policy Decisions

Taking account of the comments received to the draft decision paper (see section 2) and latest relevant developments (which were discussed in the draft decision), the SEM Committee now sets out below its decisions in relation to SEM market power, liquidity and ESB integration.

There are no significant policy deviations from the SEM Committee's proposals contained in the draft decision.

## 3.1 Market Power Mitigants

<u>*BCoP, MMU& DCs*</u>

From January to mid August 2011, ESB PG's share (including its peat plants, which are subject to a PSO) of the wholesale SEM pool was circa 28% by output, with ESBIE (Synergen and Coolkeeragh) having an 18% share. Therefore ESB has at present a circa 46% share in total by SEM market scheduled quantity.

In other words the SEM spot market at present is quite highly concentrated. However, the SEM Committee is satisfied that there has been no significant market power exercised in the spot market to date due to the relevant market power mitigation measures in place. The BCoP, MMU and DCs have helped ensure that generator bids are at competitive SRMC levels, resulting in SEM wholesale prices (SMP) that are efficient and providing the correct market signals. CEPA also believe that these measures have played a strong role in mitigating market power. In particular they noted in their December 2010 paper that:

"*the apparent success of the SEM should not be taken to mean that the BCoP and MMU should be removed, as our analysis shows that there will still be potential for market power abuse*" [p5];

and,

"*the apparent success of the BCoP and MMU suggests that these provisions are effective and will and should remain in place for the foreseeable future to militate the risk of any market power being exploited"* [p33].

With new interconnection and generation predicted in the coming years, CEPA's forward-looking modelling analysis, detailed in their December 2010 paper, indicated that ESB's RSI levels in 2015/20 would *on average* not be at levels of concern from a market power perspective. However there would still be some hours/scenarios when RSI is below 1.2, the threshold that typically suggests market power potential, linked to increased levels of intermittent generation, i.e. wind power. Therefore CEPA suggested that the RAs maintain a robust market power mitigation strategy for the foreseeable future.

In view of this and the strong support shown in the responses to the public consultations, the SEM Committee will maintain BCoP/MMU and DCs as market power mitigants for the foreseeable future. If the spot market becomes significantly less concentrated in the future, the RAs will then review these market power mitigation measures. Any changes would be subject to public consultation.

In terms of MMU transparency, as stated in section 2.2 above the MMU aims to publish a draft decision paper on MMU governance in Spring 2012.

DCs will remain based on HHI as there is no compelling reason to adopt RSI. The HHI threshold, DC levels and frequency of future DC offerings is discussed separately in section 3.3 below.

*REMIT*

In relation to the prohibition and monitoring of market power abuse, the RAs note that the "European Regulation on Energy Market Integrity and Transparency" (REMIT) was adopted as European law on 28th December 2011. REMIT includes provisions which:

(a) Prohibit spot and contracts energy market abuse across the EU, specifically market manipulation and insider trading, from 28th December 2011; and,

(b) Provide for the new European energy regulatory, ACER (Agency for the Cooperation of Energy Regulators), to receive and monitor energy market transactions at Member State and EU level, to examine if there is any ongoing market abuse. This new monitoring regime is expected to "go live" in 2013.

On 20th December 2011 ACER published guidance documents helping to explain REMIT, which may be of assistance to energy market participants, as per the link below:

http://www.acer.europa.eu/portal/page/portal/ACER_HOME/Activities/REMIT

As can be seen from these guidance documents, REMIT is expected to provide an extra level of market power abuse protection for SEM, with new market monitoring carried out by ACER in addition to that carried out by the MMU.

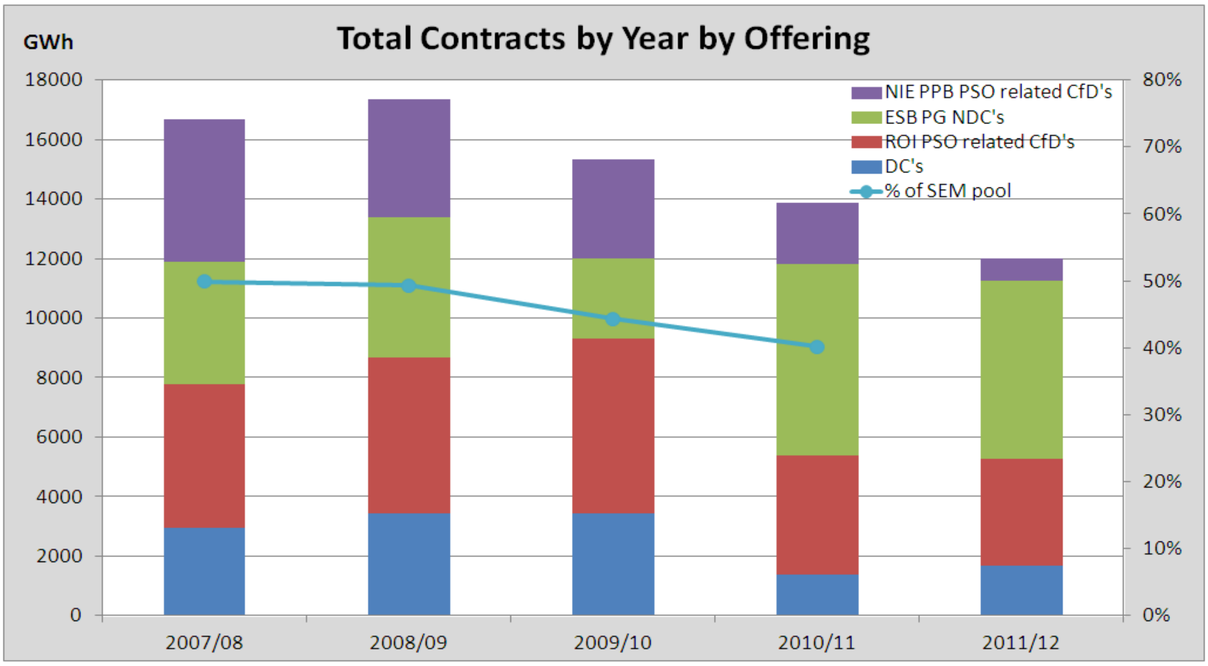
The RAs will be actively engaging with ACER and other stakeholders on this issue in the coming months. In addition, the RAs will be hosting a public workshop with interested parties to discuss REMIT and its potential implications for SEM and market participants – the workshop is planned for March and details will be provided on the RAs' website (www.allislandproject.org) shortly.

## 3.2 Background to Contracts & ESB Ring-fencing

For information, this section gives a background to contract market power and how it relates to ring-fencing, before providing specific decisions in these areas in section 3.3.

*Contracts*

The level of contract liquidity in SEM for recent years, divided between DCs, NDCs and PSO-related CfDs, is as follows.




**2011/12 statistics above are to mid January 2012 – further NDCs may be offered, and NDC offerings to date include OTC sales (rather than offerings).*

It can be seen that ESB PG NDCs, whose price is not set by the RAs, are an increasing portion of overall contracts offered (excluding private contracts among market participants), at circa 45% in 2010/11 and 50% to date in 2011/12. Hence, even if ESB continues to be ring-fenced, the exercise of *contract market power* by ESB PG is increasingly possible. In this scenario, while Electric Ireland could reduce its profits by over-paying for contracts, this would be more than compensated for by extra profits made by ESB PG, because over-priced contracts would not only be bought by Electric Ireland but also other suppliers. This strategy would also raise the price of contracts for other suppliers, leading to higher customer prices and/or negatively impacting on retail competition.

It is recognised, however, that this contract market concentration of NDCs is a feature of ESB PG voluntarily offering NDCs to the market, which is desirable from a liquidity perspective – hence the RAs encourage other parties to also offer contracts (see later).

*Vertical Ring-fencing*

In relation to the current "status quo" ring-fencing of ESB, CEPA are of the view that the SEM is working well and delivering on its objectives, including attracting significant new investment. ESB vertical ring-fencing between generation and supply prevents particular informational advantages accruing to Electric Ireland (see next section). It also facilities the ongoing regulatory oversight whereby the RAs can at least view ESB PG NDC prices, thereby limiting - though not stopping as outlined above - its ability to exercise market power in the contracts market, especially compared to a fully integrated business model. Further information is available in the CEPA report of December 2010.

## 3.3 Approach to Contracts & ESB Ring-fencing

*Vertical Ring-Fencing Continues*

The SEM Committee will not allow either the ESB full vertical integration or "partial vertical integration" options for now. All bar one respondent that commented on this issue to the draft decision agreed with this SEM Committee position. The reasons for the SEM's Committee's decision are detailed below:

- As referred to in section 3.1, in total ESB's generator units have a 46% share of the spot market. This is equivalent to a HHI level of 2,116, if ESB is allowed to horizontally integrate its generation units (see later). In other words, with horizontal integration, the spot market at present is quite highly concentrated using the internationally applied HHI measure.

- CEPA are of the view that full vertical integration is unfavourable as it could damage competition. CEPA said that ESB's generation arm would provide an automatic hedge for its retail arm, "reducing or eliminating its need to trade contracts with other market participants unless this were mandated" and that any liquidity proposal by ESB, in the context of a vertically integrated company, would only "mitigate a power that ESB does not currently hold due to ring-fencing". Please see CEPA's paper published in December 2010 for more information.

- In a fully integrated model, the fear is that contract market power potential is more significant than the status quo. This is because ESB PG could deliver below-cost contracts to Electric Ireland and above-cost contracts to other suppliers (without the RAs being aware of it) because the "Non Discrimination Offer" clause would be removed. Thus the exercise of contract market power by ESB could be even more dramatically disruptive to other suppliers and retail competition than outlined in section 3.2 above, to the long-run cost to the consumer.

- There could be informational advantages which would benefit Electric Ireland with either vertical integration option. For example Electric Ireland could know of a likely (unpublished) forthcoming ESB generator outage, so it would know to buy forward contracts, and other suppliers would not be aware of this and would be exposed to the higher SMP. Electric Ireland would also be aware of other supplier contract purchases from ESB, providing it with an advantage over other suppliers. This could have a negative impact on competition and new entry in both the retail and wholesale markets. CEPA were also concerned that vertical integration would dissuade potential new entrants who would fear that they would be subject to hard-to-monitor forms of discrimination.

- There would be a reduction in contract liquidity under ESB's full integration "liquidity undertaking". In this scenario there would be circa 2.6 TWh available to independent suppliers, under current spot market conditions between DCs and NDCs. This compares to approx. 6 TWh which has been offered to date for the 2011/12 contract year, though it is noted that that Electric Ireland buys a considerable percentage of these contracts (whereas the 2.6 TWh would be a net figure available to all other suppliers).

- While it is acknowledged that there could be more RA "contract regulation" under ESB's "partial vertical integration" option (see draft decision), along with a similar level of liquidity to present levels, CEPA are of the view that this option is unfavourable as doing so would replace a structural remedy with a likely less efficient and/or effective regulatory remedy. CEPA make the point that although the proposal would remove some existing ring-fencing restrictions on ESB, it would "require significantly more regulatory oversight, and on a more frequent basis, of the company than at present". This goes against the ultimate aim of the SEM which is to move towards less regulation. CEPA also had concerns that if partial integration was granted then it would be "easier for ESB, with its informational advantages, to argue for additional, gradual, integration over time, than to argue for the jump from full separation to full integration in one go". For more information please see CEPA's report appended to the draft decision paper.

The SEM Committee would, however, separately consider any proposals for ESB vertical integration in the context of a material change to market power in the SEM. An example of a material change would be a significant divestment of a portion of ESB's generation plant portfolio. Any proposed changes to vertical ring-fencing would be subject to separate public consultation.

Separately, there are legacy contracts between the Synergen and Coolkeeragh plants and ESBIE (now part of Electric Ireland). The RAs have examined these contracts along with current licence requirements. It should be noted that the contracts relate to the Synergen and Coolkeeragh plants only. Furthermore the licence requirements are such that no cross-subsidies between generation and ESBIE can apply with respect to this generation output. The RAs will continue to monitor the impact of these contracts.

*Allow Horizontal Integration*

Contrasting with vertical integration, the following considerations make horizontal integration of ESB generation more acceptable:

- CEPA states in the December paper that, with BCoP in place, *"the operational horizontal separation of ESB seems to have little value in promoting competition, whilst adding some cost to ESB, and thus an operational integration should be considered".* Thus it believes that horizontal ring-fencing could be removed because the operational efficiency benefits in doing so might be worth the small market power risk. This is because BCoP and the MMU help ensure that all generator bids are at appropriate SRMC levels, irrespective of horizontal integration, and indeed DCs provide further protection in this regard. There would not be the higher market power risks associated with full vertical integration (see above).

- ESB could make generation cost savings from horizontal integration, with low market power risks for the end customer. Any efficiency gain would be welcome, especially in the current economic climate.

- With current ESB ring-fencing and the planned commissioning of the East-West Interconnector later this year, it is expected that from October 2012 (the next contract year), DC volumes will drop dramatically from their current level of 1.66 TWh. Horizontal integration would, in contrast, significantly increase the quantity of DCs available to eligible market participants, due to ESB's market share in the spot market increasing. DCs would rise noticeably from the current 1.66 TWh level, probably doubling or more to circa 4 TWh, though the exact figure would depend on modelled fuel prices, etc. It is anticipated that this would largely involve a swap of ESB's NDCs for DCs. On this basis, the increase in DC volumes will likely increase the proportion of total public contracts made available that are regulated by the RAs, reducing the NDC proportion from circa 45%-50% at present (see earlier graph) to, for example, 30%, thereby reducing contract market power (see section 3.2).

In light of these considerations and the generally favourable comments to this proposal in the draft decision, the SEM Committee will allow the horizontal integration of ESB generation units, i.e. of ESB PG and ESBI (Synergen and Coolkeeragh). This will formally apply from 1st October 2012, and the RAs will work on the licence changes needed to transition to horizontal integration from early 2012 through to October 2012.

*DC Offerings*

No party that responded to the draft decision advocated reducing the 1,150 HHI threshold for DCs at present. The SEM Committee has decided that this threshold will continue for the moment. As referred to above, with horizontal integration of ESB, and applying the current HHI threshold, the DCs levels for the next contracting year (i.e. from October 2012) is expected to rise noticeably from the current 1.66 TWh level to circa 4 TWh, though the exact figure will depend on fuel prices etc. For information, if ESB were instead to remain horizontally ring-fenced, DC volumes would instead be expected to fall very substantially from current levels, due to the commissioning of the East-West Interconnector.

In February of this year the RAs will consult on the frequency of the DC offerings for 2012/13 (i.e. annual or more regular), in a similar manner to the regular process, before deciding on the matter.

## 3.4 Approach to Liquidity

The SEM Committee notes the recent developments in contract liquidity, discussed in more detail in the draft decision:

- PSO-related CfDs will continue, as confirmed by the RAs in April 2011, and regular NDC short-term products are being offered; and,

- A new Tullet Prebon "Over the Counter" (TP OTC) trading facility has commenced and should help to assist liquidity, by allowing for suppliers and generators to interact more with respect to NDC price and quantities, assisting in price discovery.

The SEM Committee considers liquidity developments best developed "organically" through industry/market initiatives rather than being mandated by the RAs, and notes that most respondents to the draft decision agreed with this view. The new OTC trading facility (referred to above) is a move in that direction.

Hence the SEM Committee doesn't consider it appropriate at this time to establish a market maker facility in which a market participant (say ESB) would be required to continuously have a buy/sell facility for contracts at all times (e.g. via an exchange). Similarly the Committee will not proceed with an option of mandating contracts from generators at this time. There could be a significant cost to industry from requiring a market maker or mandating contracts form generators, while the demand for such a continuous trading facility is unclear, and it is noted that the majority of respondents to the relevant consultations were against pursuing such options.

However, there may be a case for proceeding with such an approach in the future, in the context of the integration of SEM into European markets. This is because market-coupling with Europe could involve day-ahead CfDs. The RAs' Market Integration Project Team will lead this work and any initiatives in this area will be fully consulted on by the RAs at the appropriate time. In the meantime the RAs will meet interested stakeholders, to assist where possible in developing industry-led solutions to contract liquidity.

More generally, the SEM Committee will continue to actively monitor the spot and contracts markets for evidence of market power being exercised. If the SEM Committee becomes aware of any evidence of spot or contract market power being exercised by market participants, including the exercise of NDC market power or insufficient contract liquidity, the SEM Committee will take appropriate regulatory action to address the situation, including potentially lowering the HHI threshold for DCs. This would be subject to separate consultation at that time.

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