Response by Energia to Single Electricity Market Committee Draft Decision Paper SEM-11-089

SEM Market Power & Liquidity

16 December 2011

1. Introduction

Energia welcomes this opportunity to respond to the Single Electricity Market (SEM) Committee's draft decision paper on the important issues of market power and liquidity in the SEM. The issue of market power was and remains a fundamental aspect of the SEM, and is a necessary constraint on its design. To mitigate against the potentially damaging impacts of market power, the SEM Committee's strategy has associated benefits of providing much needed liquidity for the market. Such a review of both market power and liquidity in the SEM therefore was considered to be both timely and important. [In the context of the changes proposed in this paper, relative to those considered in the consultation paper, we note that *prima facie* there is little proposed departure from the status quo. Energia broadly welcomes the policy proposals contained in this draft decision paper but reserve specific comments for the following section wherein comments are provided on the proposed approaches to; relevant features of the market power mitigation strategy (BCoP, MMU & DCs); contracts and ring-fencing; and liquidity.

Prior to elaborating on policy proposals it is first considered important to address a procedural shortcoming of this consultation, the three week duration. An important matter such as this draft decision requires consideration by a number of internal business units in order to ensure a comprehensive response can be provided to the proposals presented. This in itself poses logistical challenges for respondents but when coupled with an extremely short consultation period, the process risks becoming unworkable. Notwithstanding the importance of the topic, Energia considers three week consultation periods in general to be, too short. Such timelines inhibit the ability of respondents to provide complete and considered responses, shows a disregard for commercial realities and is considered to be poor regulatory practice. Acknowledging the need of the SEM Committee to conclude such matters in a timely manner, it is incumbent on the RAs to manage future workstreams in a manner that allows an appropriate time, considered to be well in excess of three weeks, for any consultation with industry to be considered meaningful. Noting the indicative timelines for consultations published by both RAs, we consider a duration of 8 – 12 weeks to be appropriate and that such timelines should similarly apply to significant draft decision papers such as this one.

2. Comments on Policy Proposals

Before moving to address specific points in relation to the policy proposals contained in the draft decision paper, brief comment is first warranted on what is considered to be one of the most important proposed decisions within this paper. Energia welcomes the SEM Committee's proposal to maintain vertical ring-fencing of ESB as part of an appropriate structural approach to addressing the potential adverse impacts of their continued market power. We similarly agree with the SEM Committee assessment that reintegration proposals from ESB should be only forwarded following significant divestment of generation capacity. Comments on the proposal to allow horizontal integration are commented on below.

Proposed Approach to BCoP, MMU & DCs

Energia accepts the findings of CEPA and the views of the SEM Committee 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*". As such Energia endorses the continuation of the strategy for the foreseeable future, as proposed by CEPA having considered the introduction of new interconnection and generation.

Energia welcomes the notification that work on the MMU governance document is nearing a conclusion as this document is long overdue. As a consequence of the significant delay surrounding this issue, and given the last industry engagement was two years ago, Energia suggests that any such decision be first published in draft decision form, for consultation with industry. The significant delay in relation to this document has contributed to confusion and uncertainty in the market around the processes engaged in and binding on the MMU. Clarity on the proposed timeline and on the intention to publish a draft decision paper, as proposed herein, would be a welcome addition to this notice.

We note that arising from the proposed decisions contained in this paper (horizontal reintegration of ESB), the role of the MMU and need for clear and transparent market monitoring processes is enhanced. It is in this new context that market participants should be afforded the opportunity to review the appropriateness of comments provided in response to the RAs MMU questionnaire returned two years ago and upon which the RAs are seeking to conclude this important work.

Having previously highlighted the limitations of relying on the HHI metric in electricity markets for competition assessments, (Energia response to SEM-10-084) and noting the general acceptance of this in the academic literature, Energia is somewhat surprised to find that the basis for DC volume calculations is to remain the HHI. Furthermore, as a generally accepted superior measure of market power in electricity markets, the onus is considered to be more appropriately lie with the SEM Committee to justify the retention of the HHI as opposed to citing the absence of a compelling reason to adopt RSI.

The RSI measure is a more detailed and sophisticated metric of market power and as such we consider it to be an important metric to be reported on in future market power assessments to be undertaken by the RAs. However, in light of the decision to retain the HHI, retention of the 1,150 HHI value threshold for DC volume calculation is considered to be appropriate as any proposed change is without basis. The assertion that the current liquidity offering, when DCs are included, works well for market participants may be called into question following the decision to allow the horizontal reintegration of ESB, a matter we address further in this context below.

Proposed Approach to Contracts & ESB Ring-fencing

In light of concerns expressed in the draft decision paper over the ability of ESB PG to exercise contract market power, even where they continue to be ring-fenced, Energia suggests that proposals to address this potential abuse of market power be included in the proposals pertaining to this aspect of the market.

As already stated herein, Energia welcomes the SEM Committee's proposed decision to maintain vertical ring-fencing of ESB as an appropriate structural remedy to continuing issue of market power. As stated by other respondents, including the Competition Authority, structural remedies are to be considered superior to behavioural or other such measures and in accordance with this, are the most appropriate means to continuing to mitigate against ESB's market power. Further to the CEPA analysis of ESB's alternative reintegration proposals, Energia cautions against relying solely on the CEPA findings in relation to the 50% proposal that were found to bring about little to no change in market power metrics. Crucially from a competition policy perspective, such metrics should never be considered in isolation, a point reiterated by the Competition Authority in their response. Energia notes that investigations undertaken by the European Commission's DG Competition have found companies in the energy sector across Europe guilty of abuse of market power with market shares as low as 20%. This finding reinforces the need for the continuation and enforcement of the RAs market power mitigation strategy, including the vertical ring-fencing of ESB.

Further to our response to the associated consultation paper (SEM-10-084), Energia remains unsupportive of the SEM Committee proposal to allow the horizontal reintegration of ESB's generation activities. We caution that as a result of the adoption of the SEM Committee's proposed decision, increased reliance will be placed on the market power mitigation strategy and the effective role of regulation in the market will be necessarily increased. While acknowledging the potential benefit for liquidity through the required increase in the volume of DCs to meet the HHI threshold of 1,150, Energia does not expect to see any increase in the overall volume of contracts made available by ESB to the market. The increased dependence on DCs, to mitigate against ESB's increased market power, is expected to impact negatively on the volume of NDCs made available to the market. The likely offsetting of increased DC volumes by lower NDC volumes places a greater reliance on regulatory intervention in the market and may restrict the development of products in the market, particularly if DC products are to remain as inflexible as their current offering. Contingent upon the DC offering, such an outcome could impact negatively on liquidity, albeit as a side-effect of addressing the primary issue of market power.

Energia endorses the intention of the SEM Committee to continue to monitor the market and address any significant falls in the levels of liquidity, where this is demonstrated to arise from market power we consider the suggested lowering of HHI threshold for DCs to be an appropriate response. However, it is our considered view that falling liquidity could arise irrespective of changes to the market power metrics and in such a context a change to the HHI threshold may not be an appropriate response. Should it be considered to be a justified response, we would suggest that there may be a wider range of options available to the SEM Committee, including, mandating NDC volumes on ESB as the only market participant capable of providing significant levels of liquidity, or a market maker facility to be provided by ESB.

Energia notes the SEM Committee's commitment to hold a consultation on the DC offering in due course. However, it is Energia's considered view that the decision to allow for the horizontal reintegration of ESB, and the subsequent necessary impact on DC volumes required to mitigate against the increased market power of ESB, risks changing the balance of contracts to be offered the market. It will therefore be important to consider a significant revision of current DC products such that the current balance required by the market is at least maintained and preferably improved with DCs required to play more of a role in short term and rolling product offerings.

Further to the market developments with respect to liquidity and the development of the OTC platform to be discussed subsequently, Energia notes that to the extent that volume was to migrate from the NDC auctions to the OTC platform, this may be restricted by any offsetting reductions in NDC volumes for increases in DC volumes. This is of particular concern if the remaining NDC volumes do not fit with the requirements of suppliers in the market, due to the nature of the contracts offered.

It is also important to note that the potential reduction in the volume of NDCs is not considered to be a legitimate basis for failing to propose formal mechanisms for monitoring and assessing ESB PG's exercise of market power in the contracts market, as outlined at the start of this section.

Proposed Approach to Liquidity

Firstly, Energia welcomes the continuation of the PSO-backed CfDs.

In light of the points made with respect to the proposal to horizontally reintegrate ESB, Energia have reservations over the role of NDC auctions in the future and their ability to continue to provide the required balance to the contract offerings in the market. Similarly, any reduction in NDC volumes also reduces the scope for NDC volumes to migrate to the OTC platform.

The development of the OTC trading facility is a welcome forward step with respect to liquidity in the SEM and Energia welcomes the SEM Committee's proposed decision to allow for further developments to emerge absent any mandating of requirements from the RAs. However, Energia notes that to date the most significant benefit of the OTC facility, with respect to the market, is not what it has delivered for the market but rather what it has the potential to deliver. Further development of this facility requires a commitment by ESB, as they are the only market participant capable of providing significant and required levels of liquidity, , to do so through the platform.

In the OTC windows to date, relatively small volumes have been offered and traded and significant improvements on this will be required before this nascent development can confidently be considered to address the liquidity needs of the market. Developments that may restrict the potential of the OTC are, in this context, unwelcome.

Furthermore, it is important that in taking any decision to increase reliance on the market power mitigation strategy of the SEM (including the role of DCs), that this be done having regard to the potential implications of such a decision. The mitigation of market power is considered to be a primary concern for the market but it is important that this strategy is advanced, as far as possible, in a manner that ensures liquidity is not adversely impacted vis-à-vis the status quo or alternative approaches. Through an increased reliance on regulated DCs to provide liquidity, as a consequence of market power mitigation, any future reduction in liquidity may be more appropriately dealt with through additional liquidity requirements as opposed to relying further on DCs.

As noted already in this response, we urge the SEM Committee to be mindful of implications arising from their decision to increase both ESB's market power and the necessary reliance on DCs. In instances where levels of market based, as opposed to regulated, liquidity falls substantially and thus impacts on overall liquidity in the market, (including breadth and depth of products), it is considered to be both appropriate and prudent for the RAs to investigate such matters and, through consultation with industry, implement appropriate remedial measures.