



**Consultation on the Market Monitoring Unit
(MMU) Governance Process Manual –
SEM/10/085**

Viridian Power & Energy Response

25 February 2011

Introduction

Viridian Power and Energy (VPE) welcomes this consultation and the publication of a proposed Market Monitoring Unit (MMU) Governance Process Manual. Although the proposals are largely disappointing and unambitious, we recognise that this is a consultation process. VPE has a vested interest in having a well-functioning, efficient, and competitive market and recognises the role of the MMU in conjunction with the Bidding Code of Practice (BCoP) as integral to the SEM market power mitigation strategy. We therefore provide constructive feedback in this response based on our experience of operating in the SEM as an independent energy provider.

It would appear that the proposed process manual is intended to largely replace the existing process in Information Paper AIP/SEM/07/511. Whilst there are some positive proposals (the Traffic Light Report and the Enforcement Journal) most aspects of the paper are a retrograde step, notably in relation to the timeliness, objectivity and autonomy of MMU investigations and reporting. VPE recognises the MMU as the competent authority in market monitoring and believes its status as such should be recognised by the regulatory authorities (RAs) and reflected in the Governance Process Manual. VPE notes from the consultation paper that only 50% of MMU time is spent on market monitoring activities. This raises some serious questions, and it would suggest the MMU currently has insufficient autonomy to focus on its core work of market monitoring.

In summary, we suggest the need to enhance:

1. **Transparency** – the significant benefits of transparency in the context of market monitoring are well known and understood. For example transparency is known to facilitate peer monitoring and promote the development of a competitive and liquid market. Whilst broadly welcoming the initiative to publish a Traffic Light Report (TLR) we strongly suggest that considerable enhancements in the transparency of MMU monitoring activities, investigations and reporting are necessary and feasible. We specifically suggest: (a) increasing the frequency of TLR updates; (b) publishing reports following all formal investigations; (c) publishing reports following informal inquiries, particularly leading to a change in bidding behaviour; (d) publishing regular MMU market updates; (e) providing more information about the ‘Shadow MMU Manager’; and (f) conducting an annual external audit of the Enforcement Journal and publishing the auditor’s report.
2. **Timeliness** – there is considerable scope and need to improve the timeliness of MMU investigations and reporting, and resulting enforcement actions. Based on

our experience we suggest reducing the timelines for investigating and reporting suspected departures from the BCoP. This is of particular importance in the context of ex post monitoring and limited punitive measures that do not give adequate incentive for compatibility. Timeliness is also vital for market participants that are adversely affected by inappropriate behaviour.

3. **Objectivity** – it is important to provide clear, consistent, and objective criteria for the monitoring function and resulting enforcement actions. We particularly stress the need for clear and objective criteria for classifying complaints and for triggering investigations. This would enhance transparency and would give market participants (and potential new entrants) greater confidence that the BCoP and Short Run Marginal Cost (SRMC) bidding principles are applied rigorously, impartially and consistently. It would also help to rule out frivolous complaints because market participants would know not to raise complaints that did not fulfil the stated criteria. VPE is very concerned about the vague, incomplete, and inappropriate basis proposed in the consultation paper and the process manual for classifying complaints and for triggering formal investigations. In particular VPE strongly objects to the proposed test of “having a major impact on the market” for classifying complaints, initiating formal investigations (or indeed informal inquiries), and presumably for triggering enforcement actions. The market and its participants rely on the objective monitoring and enforcement of SRMC and BCoP bidding principles and would have no confidence in the test proposed. The impact on market participants of inappropriate bidding / behaviour needs to be recognised as per the current process in AIP/SEM/07/511.

4. **Independence** – the MMU should be recognised as the competent authority in market monitoring and should be given sufficient autonomy and, guided by a clear process and mandate (with minimal interference from the RAs), use its best judgement to carry out its monitoring and reporting function expeditiously and with impartiality. MMU independence is not evident in the consultation paper or the proposed process manual and this undermines confidence in the market monitoring function. It also frustrates the timeliness of MMU investigations and the perception of impartiality. VPE furthermore has a particular concern with the new information on page 25 of the consultation paper concerning the ‘Shadow MMU Manager’ within CER who has worked jointly with the MMU Manager in determining whether an issue merits a formal investigation. References to the ‘Shadow MMU’ do not appear in previous documents and despite numerous formal and informal interactions with the MMU, we were not aware of the Shadow MMU Manager’s existence. This is of concern given the apparent role of this individual in MMU decision making. We need to further understand the role of the ‘Shadow MMU Manager’ but would strongly caution against this individual having influence over MMU decision making.

It is our considered view that the above measures, reflected in a revised MMU Governance Process Manual, will significantly enhance the functioning of the MMU and market confidence in it. Crucially these benefits will only be realised if the process manual is adhered to. Whilst we recognise the need for discretion and flexibility, as flagged on page 4 of the proposed manual, this should only be used in exceptional circumstances and should be fully justified and reported. Otherwise any unexplained exception will undermine the purpose of the process manual. VPE has raised concerns about this based on past experience when a formal complaint we raised was investigated and upheld but the published procedure (AIP/SEM/07/511) for dealing with this was disregarded in materially important respects without an adequate explanation. Specifically, the formal complaint was not published, the timelines were not adhered to, and the final report and outcome was not communicated to the market. We would urge the RAs not to let this happen as it undermines confidence in the integrity of the process and all that it aims to achieve. We would therefore suggest that any material departures from the process be clearly justified and communicated to the market in the Traffic Light Report (or otherwise) and documented in the Enforcement Journal, and that such deviations only be permitted in exceptional circumstances.

A key function of procedures in any organisation is to provide clarity, consistency, and control in the execution of important policies. To achieve these aims, process manuals need to be clear, unambiguous and comprehensive, providing minimal scope for discretion. This is of great importance for example in the trading departments of companies such as VPE and is even more important in the context of market monitoring to ensure that licence holders comply with the BCoP and SRMC bidding principles given the potentially significant, immediate, and unrecoverable adverse consequences of non-compliance, either for the market as a whole or for individual participants. Market confidence (central to liquidity, competition, and efficient investment) relies as much on the visibility of monitoring and enforcement as compliance itself and therefore it is crucial that the MMU activities and resulting enforcement actions be seen to follow a very clear, unambiguous and unbiased process independent and free from political influence. The proposed process manual is too vague and discretionary in many important respects and does not therefore provide the market assurance required. We strongly believe that a more transparent, timely, objective and independent process that is only deviated from in well explained and exceptional circumstances will add significantly to the real and perceived effectiveness of the market monitoring function which is essential for a well-functioning, efficient, and competitive market.

Finally, VPE is aware that the RAs commissioned CEPA to conduct a review of the MMU governance arrangements in 2009 with a remit of assessing, amongst other things, how well the MMU was performing its functions and identifying areas that could be improved. As part of this review, market participants were invited on 9th

October 2009 to complete a comprehensive and probing questionnaire¹. VPE would urge the RAs to publish the final recommendation report produced by CEPA in the interests of transparency, especially when the current consultation and proposed process manual is guided by CEPA's recommendations.

The remainder of this response provides more detailed comments.

¹ See http://www.allislandproject.org/en/mmu_decision_documents.aspx?article=33ba58e8-5d27-40a2-8d33-562c90b5986e.

Detailed comments

1. Transparency

In line with best international practice VPE would strongly encourage measures to increase the transparency of MMU monitoring activities, investigations and reporting because this assists the market monitoring process through peer monitoring and discourages inappropriate behaviour. It also helps to promote confidence in the efficient operation of the market and serves as a commitment for the regulatory process to maintain its consistency and independence.

In addition, we refer to CEPA's independent report on market power and liquidity in the SEM (SEM-10-084a) dated 15th December 2010 which is presumably informed by their review of the MMU's governance arrangements. It identifies transparency as a key factor in promoting the development of a competitive and liquid market, noting that the price formation mechanism needs to be seen as sound and transparent, and, in this context, recommends increased transparency in the operation of the MMU, including its investigations and reporting.

Whilst VPE acknowledges the transparency undertaking of the SEM Committee (SEMC) in relation to the MMU investigation process there is considerable scope to enhance the transparency of the process as follows, which VPE would strongly encourage:

a) Update the published Traffic Light Report more frequently than proposed

As noted in our introductory comments VPE supports the proposal to publish a Traffic Light Report as this should improve transparency of MMU activities and investigations. However we strongly suggest this report needs to be updated much more frequently than monthly. We therefore suggest the following updates which would add significant value for a minimal increase in workload:

- Level 3 (formal investigation) updates be provided on a daily basis
- Level 2 (high concern) updates be provided on a daily basis, and that
- Level 0 and 1 (low to medium concern) updates be provided on a weekly basis

b) Publish reports following *all* formal investigations

According to the consultation paper and proposed process manual there is only an undertaking to publish a report when the outcome results in Enforcement Level C actions involving the SEMC issuing a formal direction under licence in order to secure compliance. Acknowledging that a brief report *may* be published following Enforcement Level B actions, this does not sufficiently commit to transparency of formal investigation outcomes. We have a particular concern with generators considered in breach of the BCoP not being reported if they agree to change their behaviour. We strongly suggest that a report narrating the case and its outcomes be published following the conclusion of *all* formal investigations. This will help ensure the consistent and correct interpretation of the BCoP, and that market participants do not act in undesirable ways because they did not understand the likely consequences.

We refer specifically to a formal complaint we made last year which was not published or communicated to the market contrary to the process in AIP/SEM/07/511. Our complaint was formally investigated and subsequently upheld but a report of the findings was not published. As noted in our introductory comments, we would urge the RAs to be more transparent and to adhere to the process going forward. We would also request the retrospective publication of all formal complaints, investigations and outcomes. This suggested approach would help to ensure that the MMU's actions are understood by all market participants, and that market participants do not act in undesirable ways because they did not understand the likely consequences.

c) Publish reports following informal inquiries

According to the consultation paper and proposed process manual the MMU can request that a party amend its behaviour if it considers that party to be in breach of the BCoP following an informal inquiry. If the party agrees to amend its behaviour, the MMU will close the case and remove it from the Traffic Light Report without necessarily publishing a report of its findings. Instead, "the MMU may, with the permission of the OC publish a short statement of its findings" (p. 19 of the proposed process manual).

VPE would again stress the need to publish a report, especially when a generator is considered to have been in breach of the BCoP. We would furthermore suggest that the MMU be compelled by process to publish such reports unless the Oversight Committee (OC) intervenes and that any such intervention only be made in clearly explained exceptional circumstances logged in the Enforcement Journal and published in the Traffic Light Report.

- d) Publish regular MMU market reports of its analysis and investigations

According to AIP/SEM/511/07 it was envisaged that the MMU would publish quarterly market assessments. VPE would encourage this and given that the MMU already produces daily, fortnightly, monthly and annual reports and presentations for the RAs, the OC and SEMC it should be relatively straightforward to publish market assessment on a more frequent basis, notably weekly and monthly. We note that regular reporting of this nature is undertaken by most market monitoring organisations and that similar reporting in the SEM would be very useful. We acknowledge that the detailed annual report, last published in April 2009, was reasonably useful but unfortunately a lot of the information reported was out of date by the time of publication and hence more frequent reporting would be necessary to supplement the Traffic Light Report.

- e) Provide more information about the 'Shadow MMU Manager'

As discussed in our introductory comments we have a particular concern with the new information revealed on page 25 of the consultation paper concerning the 'Shadow MMU Manager' within CER who has worked jointly with the MMU Manager in determining whether an issue merits a formal investigation. Despite numerous interactions with the MMU, both formally and informally, we were not aware of the Shadow MMU Manager's existence which is very concerning given the apparently important role of this individual in MMU decision making. There is also no reference to a 'Shadow MMU Manager' in other publications to date covering the MMU framework. For these reasons we strongly suggest the need for greater transparency in this space and would strongly caution against a requirement for the 'Shadow MMU Manager' to be consulted with before the MMU asks the OC to launch a formal investigation as this undermines confidence in the MMU and its autonomy and would further contribute to the protracted timelines of the formal investigation process.

- f) Conduct an annual external audit of the Enforcement Journal and publish the auditor's report

We would strongly encourage keeping a detailed record of MMU activities, deliberations and decisions in an Enforcement Journal as described in the consultation paper and would extend this to include all Shadow MMU, OC and SEMC interventions. We furthermore suggest that this should be subject to an annual external audit, with the auditor's report published, as this would enhance market confidence in the functioning of the market monitoring process.

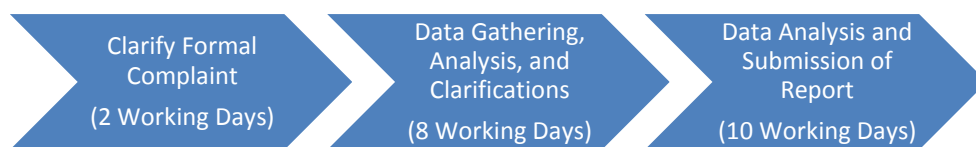
2. Timeliness

VPE is very concerned with the protracted timelines of the formal investigation process that are broadly outlined in the consultation paper and the proposed process manual. As already noted in our introductory comments, an expedited process for investigating formal complaints is especially important in the context of ex post monitoring and limited punitive measures that cannot ensure incentive compatibility or that market participants adversely affected by inappropriate behaviour / bidding are appropriately compensated.

Based upon our assessment of the information provided, a formal investigation could take at least 2 months from when it is sanctioned by the Oversight Committee to when a report is submitted by the MMU to the same committee. Based upon this report we understand the Oversight Committee will then determine whether the matter warrants referral to the SEMC, and, if it does, the report will be submitted to the party being investigated to consider and respond with their representations within 20 working days. The SEMC will then consider the MMU report along with the party's representations and will arrive at a final determination in due course.

It is clear from the above that the process, from beginning to end, is likely to take considerably longer than 3 months. Importantly, this does not take into account any deliberations or informal investigations that precede the MMU's request for a formal investigation to the Oversight Committee and the time needed for the committee to convene a meeting to consider this and make a decision. Neither does it take into account any deliberations of the Oversight Committee in determining if a matter warrants referral to the SEMC. This compares with a total of 2 months according to the existing process in Information Paper AIP/SEM/511/07 which states that "if a formal investigation is required, the MMU will endeavour to complete an investigation for submission to the SEM Committee within 2 months of receiving an application" (p. 18). In making this comparison it is important to stress that the existing process seems to give the MMU greater autonomy in deciding to launch a formal investigation and the criteria for lodging a formal complaint are more clearly defined. We therefore submit that the new proposed process takes a retrograde step in terms of timelines and we already considered the existing process unnecessarily protracted.

Based upon our experience we suggest that it should be feasible for the MMU to complete a formal investigation and submit its report to the OC within 1 calendar month of receiving a formal complaint (that is considered valid according to published criteria) – see suggested timeline of activities and further comments below.



- By definition a complainant has every incentive to cooperate fully with the MMU in its investigation and could easily clarify all aspects of a complaint with the MMU within 2 working days of being submitted.
- If we were investigated we could, in normal circumstances, provide data and any clarifications requested by the MMU within 8 working days, noting that the MMU and market participants should already have most of the data normally required to hand.
- We consider that 10 working days is adequate for the MMU to complete its data analysis and formal report for submission to the OC.
- The above timelines could be further reduced if a formal complaint was previously the subject of an informal inquiry, as we understand is often the case.
- We strongly suggest that the basis for accepting a formal complaint and proceeding with a formal investigation be clearly specified in the process manual as per Information Paper AIP/SEM/511/07 because this would expedite the process, remove the discretionary nature of initiating a formal investigation, enhance the independence of the MMU, and ensure consistency and the perception of impartiality.
- We consider it appropriate for the MMU to be recognised as the competent authority in market monitoring and for OC intervention to be minimal. Thus we suggest the MMU be compelled to proceed with formal investigations guided by the process and that this course of action only be overruled by the OC in exceptional circumstances, with a detailed explanation given and published in the Traffic Light Report and recorded in the Enforcement Journal.
- Notwithstanding the above we strongly suggest that OC approval in the process be given priority status of a 2 working day turnaround.
- We suggest that any extensions to the above process be considered on a case by case basis and be clearly justified in the Enforcement Journal and published in the Traffic Light Report.

3. Objectivity

To reiterate our introductory comments, it is important to provide clear, consistent, and objective criteria for the monitoring function and resulting enforcement actions. We particularly stress the need for clear and objective criteria for classifying complaints and for triggering investigations. This would enhance transparency and would give market participants (and potential new entrants) greater confidence that the BCoP and SRMC bidding principles are applied rigorously, impartially, and consistently. It would also help to rule out frivolous complaints because market participants would know not to raise complaints that did not fulfil the stated criteria.

As drafted, the proposed process manual provides considerable scope for discretion and ambiguity. For example it is not clear what criteria would be used by the MMU to classify a particular case as 0, 1, 2, or 3, or to launch an informal inquiry. Specifically:

- Page 17 of the proposed process manual states that an informal inquiry would not be conducted in the event that a complaint “is frivolous or does not merit SEM resources”.
- Page 15 of the proposed process manual describes a level 2 case as urgent because “it may have a significant impact on the market”.
- Page 26 of the consultation paper states that formal complaints submitted by market participants can be effectively downgraded to level 0, 1, or 2 status by the MMU “when the matter is relevant and worthy of consideration but of a trivial nature”.

The above guidelines are vague, incomplete and are open to interpretation. Even more concerning is the stated basis below for recommending a formal investigation.

- Page 28 of the consultation paper states that “If the MMU considers that the suspected breach would have a major impact on the market, it will bring the case to the Oversight Committee and ask the Oversight Committee’s permission to launch a formal investigation”.

This would constitute a major departure from the existing process whereby a formal complaint can be made and formally investigated on the basis of detailed information and supporting evidence regarding the basis of the complaint and the manner in which the applicant is affected. This rightly covers any suspected breach of the BCoP that has substantiation. The revised basis for initiating a formal investigation is open to interpretation and bias and would be unacceptable to VPE. Inappropriate bidding for example could easily have a major impact upon a market participant

without necessarily triggering a formal investigation and enforcement under the proposed test of “having a major impact on the market”.

We have already recommended an annual audit of the Enforcement Journal elsewhere in this response and we strongly suggest its terms of reference include ensuring that all informal and formal complaints have been acted upon appropriately following objective criteria. We furthermore suggest that if the OC intervenes in formal investigations this should be clearly explained and recorded in the Enforcement Journal. Finally, we suggest that independence of the MMU will further help to instil confidence in the objectivity of the process, as discussed in more detail below.

4. Independence

According to the proposed process manual the OC must give the MMU permission to launch a formal investigation at all times. This would seem unnecessary where there is a clear basis for launching a formal investigation. Rather than review this on a case by case basis which would be a significant departure from the current process VPE would highly recommend that the MMU be recognised as the competent authority in market monitoring and for OC intervention to be minimal. Thus we suggest the MMU be compelled to proceed with formal investigations guided by the process and that this course of action only be overruled by the OC in exceptional circumstances, with a detailed explanation provided in the Enforcement Journal and published in the Traffic Light Report.

More generally the MMU should be recognised as the competent authority in market monitoring and should be given sufficient autonomy (with minimal interference from the RAs) to use its best judgement, guided by a very clear process and mandate, to carry out its monitoring and reporting function expeditiously and with impartiality. This degree of independence is not evident in the consultation paper or the proposed process manual and this undermines confidence in the market monitoring function. It also frustrates the timeliness of MMU investigations and the perception of impartiality.

We also have a particular concern with the new information on page 25 of the consultation paper that there is a ‘Shadow MMU Manager’ within the CER who has worked jointly with the MMU Manager in determining whether an issue merits a formal investigation. Despite numerous interactions with the MMU, both formally and informally, we were not aware of the Shadow MMU Manager’s existence which is very concerning given the apparent role of this individual in MMU decision making. We have discussed this earlier in the context of transparency but would emphasise here that having a ‘Shadow MMU Manager’ is incongruent with MMU independence.

Ultimately we suggest the RAs need to demonstrate confidence in the MMU and increase its independence and this will instil market confidence in the efficient operation of the market and the price formation process. As suggested elsewhere in this response, greater MMU independence should be coupled with measures to significantly enhance the objectivity and transparency of MMU monitoring and investigations. From a governance perspective it would also be important to conduct an annual audit of the Enforcement Journal and to publish the auditor's report.

As a final point we note that only 50% of MMU time is spent on market monitoring activities. This raises some serious questions, as highlighted in our introductory comments, and it would suggest that the MMU currently has insufficient autonomy to focus on its core work of market monitoring.