



**Energia response to I-SEM Market Power
Mitigation Discussion Paper**

Discussion Paper SEM-15-031

19 June 2015

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1. Introduction

This submission provides Energia's views on the scope and approach proposed to be taken in respect of the Market Power Mitigation workstream outlined in Discussion Paper SEM-15-031.

Through the I-SEM and DS3 market reform process the SEM Committee has demonstrated its preference for competitive market mechanisms. This represents a significant departure from current regulatory arrangements, and presents significant new risks and challenges in relation to market power and competition. For these reasons Viridian commissioned NERA to review the Discussion Paper on Market Power Mitigation in I-SEM (SEM-15-031) to help inform the scope and approach of this important workstream. Energia invites the Regulatory Authorities (RAs) to review the NERA Report, which is submitted in full along with this response, and we are able to facilitate a meeting with NERA to discuss the content of the report, if that would be helpful. We also reference selected extracts of the NERA report throughout this response.

The remainder of this response provides general comments in section 2 and answers to the Discussion Paper questions in section 3.

2. General Comments

Promoting effective competition

The change in regulatory philosophy noted above has been explained in the context of I-SEM as a *"Preference for a competitive approach that is in the interests of consumers, in accordance with the statutory duties of the SEM Committee"*¹. And similarly in the context of DS3, as follows: *"The SEM Committee, in line with its primary responsibility to protect the interests of consumers, favours a competitive approach to the procurement of system services"*². In relation to DS3, the SEM Committee importantly recognised that *"...insufficient competition may lead to significantly worse outcomes for consumers than otherwise..."* [ibid, page 25] and therefore a decision was taken to apply a regulatory approach to the procurement of system services where sufficient competition does not exist. It was concluded that *"...the best outcomes for consumers can be described as competition where possible, regulation where necessary..."* [ibid, page 25].

In this response we appeal to the SEM Committee's principal statutory duty to protect the interest of consumers wherever appropriate by promoting effective competition, bearing in mind (as already acknowledged by the SEM

¹ I-SEM HLD Decision, SEM-14-085, page 6

² DS3 HLD Decision, SEM-14-108, page 25

Committee) that regulation is necessary where competition is not possible, or is ineffective.

The principal source of potential market power in the all-island market remains the dominance of the state owned incumbent. Dominant players can inhibit competitive markets reaching socially optimal outcomes, a market failure that requires targeted regulatory intervention to promote effective competition in the interest of consumers.

Risk of foreclosing competition

The market power mitigation workstream should mitigate the capability to exercise market power and should actively seek to prevent foreclosure of competition by dominant participants. Foreclosure of competition is a major concern in the all-island market because of the continued dominance of the state owned incumbent which may not operate with commercial incentives. As NERA observe³:

“Because of ESB’s position as a (large) state-owned enterprise, it will be necessary to consider the possibility of ESB using its market power to achieve political objectives, rather than to raise its profits. As a state-owned company, ESB may not operate with entirely commercial objectives. For instance, it may come under pressure to lower energy prices, leading to predation, or it may be driven by management objectives to maintain or expand its market share, even when it would be unprofitable to do so.

However desirable such behaviour may seem from a political point of view, it would be inimical to competition and need not operate in the interests of all electricity consumers. The assessment of ESB’s market power and the design of MPM measures should not therefore be limited to actions that would raise ESB’s profits. The SEM Committee should consider a wider range of possible actions that would harm competition, including actions intended to lower prices (temporarily at least) and/or increase ESB’s market share.”

“Super dominant” position in the forward contract market

The state owned incumbent holds a “super dominant” position in the forward contracts market, which clearly demonstrates its capability to foreclose competition and exert significant market power in this timeframe. Concerns regarding this market are further heightened by the conclusions reached by Baringa that “[a]nalysis of the current SEM forward market indicates exceptionally low levels of market led liquidity and exhibits dynamics that could be indicative of the exertion of market power.”⁴

³ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, page 10.

⁴ Baringa, ‘I-SEM HLD Consultation: Promoting forward liquidity and mitigating market power in the I-SEM’, 6 April 2014, page 26.

Forward market prices are the main drivers of retail pricing levels. Therefore exertion of market power in the forward market increases costs to consumers, either through reduced retail competition, or directly via the pass through of the premiums paid by suppliers on hedging products. Energia's specific concerns in this area relate to the capability of the state owned incumbent to virtually vertically integrate and financially withhold forward contracts. Energia would stress that the practice of financially withholding could create the illusion of liquidity if a dominant entity engaging in such practices was selling volumes between its ring-fenced generation and supply companies.

In the absence of a structural remedy, Energia requests a substantial increase in the volume of directed contracts, combined with careful monitoring of the dominant entities' hedging activities.

Capability to exert market power in spot energy, capacity and ancillary services markets

The regulatory philosophy of pursuing 'competitive' market mechanisms increases the capability of the dominant entity to exert market power, and confers upon it, relative to other market participants, significant potential benefits as the owner and operator of the only large, fuel diverse portfolio in the all-island market. These benefits include: the ability to implement portfolio bidding strategies within (and across) energy, capacity and ancillary services markets; information advantages under 'competitive' mechanisms; the new capability under I-SEM energy trading arrangements to exert market power on the buy side of the market;⁵ and the ability to net imbalances across its generation portfolio (and consequently the capability to potentially withhold liquidity from the intra-day market to the detriment of competition).

Conventional constraints on market power may not bind

Energia emphasises that the ability of suppliers ("demand") to respond to the exertion of market power in the I-SEM forward market is negligible. This is because remaining unhedged would expose them to price volatility in the spot market (e.g. commodity price shocks, extreme cold weather, low plant availability, high wind, etc.), while hedging underlying commodities, as an alternative to purchasing forward contracts, leaves them exposed to fuel basis risk.⁶ Neither of these alternatives are therefore sustainable options and therefore "willingness to pay" (the constraint referenced in paragraph 2.2.5 of

⁵ We note from Figures 2 and 4 on pages 15 and 16 of the Discussion Paper that ESB holds a 39% share of the retail market, as well as a 47.5% share of the wholesale spot market. This could provide extensive capability to exert market power under I-SEM energy trading arrangements.

⁶ Sources of fuel basis risk are any spot market price drivers that are not related to underlying commodity prices.

the Discussion Paper) will not act as a sufficient constraint on the capability of the dominant entity to exert market power in the forward market.⁷ As NERA observe⁸:

“The Discussion Paper ... argues primarily that the forward market will right itself if market power is mitigated in the spot market, as long as market participants arbitrage the two (‘can choose not to contract at a price that is above their expectations of the spot price’). However, it also recognises that market power can be exercised separately in the forward market, specifically if suppliers ‘need to buy forward hedges to reduce the risk of exposure to the volatile physical spot market’. ...

...In practice ... the caveat recognised by the SEM Committee remains a cause for concern – suppliers do need to buy hedges to reduce their risk exposure and would be vulnerable to any exercise of market power.

...The need to hedge risks by buying electricity forward creates an opportunity for the exercise of market power when suppliers are faced with a larger vertically integrated incumbent that is less risk averse or has less need to manage risks. That incumbent can exploit the demand for hedges to raise the premium at which forward contracts trade above expected spot prices (whether or not the spot price is set competitively).”

Energia would also observe that the constraints on market power presented in paragraph 2.2.6 of section 2.2 of the Discussion Paper (i.e. existing competitors, new potential competition or exertion of buyer power), also do not bind if the motive for exerting market power is to foreclose competition. If the dominant party is capable of engaging in non-commercial activity, such as predatory pricing, or increasing market share beyond what is commercially optimal, then none of the measures identified can mitigate such behaviours. Rather mitigation requires appropriate regulatory intervention. While Energia acknowledges structural solutions are out of scope of the market power mitigation workstream, we would stress that they are the most effective way to remove the dominant entity’s market power given the extent of its capability to exert market power under I-SEM and DS3 arrangements.

Primary focus of market power mitigation workstream

⁷ With regards to the discussion on the form of contracting in the I-SEM forward market, presented in paragraph 2.2.4 of section 2.2 of the Discussion Paper, please cross reference our answer to question 10 in section 3 below, where we argue that the primary barrier to entry for non-asset backed traders is low liquidity, not the form of forward contracting. Energia has consistently maintained that physical contracting and self-scheduling would significantly reduce barriers to forward market entry, and provide additional forward market liquidity, by removing scheduling risk from the I-SEM energy market design. This in turn would expand the number of thermal generating companies in I-SEM that could participate in the forward market.

⁸ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, pages 12-13.

Energia therefore recommends that effective mitigation of the dominant entity's market power across all I-SEM and DS3 markets must be the primary focus of the market power mitigation strategy to help develop the conditions required to support effective competition under I-SEM and DS3. As NERA observe⁹:

“Typically, competition authorities: (1) assume that market participants may have a dominant position if they possess market shares above 40 per cent, (2) presume that market participants do have a dominant position if they possess market shares above 50 per cent; and (3) presume that market participants are “super dominant” if they possess market shares above 80 per cent.

The market shares presented by the SEM Committee show that, by these standards, ESB has a share that would be consistent with a dominant position in installed capacity and super dominance in Contracts for Difference (see the figure on page 15 of the Discussion Paper). If the SEM Committee were to adopt narrower market definitions by geography or by period of delivery, ESB's market shares in those segmented markets might increase further. Moreover, ESB has the largest market share in both generation and supply segments and has three times as much capacity as its competitors by any measure presented in the Discussion Paper. Thus, all the measures of market power suggested by the SEM Committee point towards including ESB in the proposed arrangements for market power mitigation.”

Need for a targeted approach to mitigating market power

In the interests of maintaining and encouraging competition under 'competitive' mechanisms, an appropriate balance needs to be struck between effective mitigation of the dominant entity's market power and the legitimate risk management activities of non-dominant participants. If ex-ante mitigation measures are too prescriptive they will undermine legitimate commercial activities. If they are too lax they will not effectively address the capability of the dominant entity to exert market power. Either outcome could undermine conditions for competition. On the other hand, the burden of proof under ex-post monitoring may mean that this method is unlikely to be sufficient to mitigate the extensive capability of the dominant entity to exert market power under I-SEM and DS3 trading arrangements. In the absence of structural solution, Energia therefore recommends that a targeted approach to mitigating the market power of the dominant entity be considered. As NERA comment¹⁰:

⁹ NERA, 'Review of Market Power Principles for I-SEM', 18 June 2015, page 7.

¹⁰ NERA, 'Review of Market Power Principles for I-SEM', 18 June 2015, page 7.

“If some of the same measures show other market participants do not have market power, the SEM Committee should take care not to include them in a blanket restriction without good reason. It is harmful to competition to design thresholds that include market participants unnecessarily, since Market Power Mitigation Measures (“MPM Measures”) can discourage competitive behaviour as well as non-competitive behaviour (see discussion of the principle “enabling competitive entry and exit” in chapter 5 below). In such conditions, it makes sense to extend MPM Measures only to those market participants that appear to possess market power by a number of different measures.”

Commercial risk profile of the dominant entity

Energia would emphasise that the commercial risks faced by the dominant entity under ex-ante bidding rules would be significantly less than other participants because of its large, fuel diverse generation portfolio, which also provides it with significant insulation from scheduling risk and the risk of forced outage. If one of its generating units is unavailable, or not scheduled, then it is highly probable that another unit from its portfolio will be scheduled in its place. Therefore Energia would expect its pricing of risk in forward contract sales to be significantly more competitive than other generation companies operating in the I-SEM.¹¹ It should also be stressed that a non-vertically integrated, commercially motivated, generation company has exactly the same requirement to manage commercial exposures to electricity spot prices as standalone suppliers. Therefore such a company should not expect to receive a premium for engaging in forward transactions of mutual benefit to both parties. Indeed, it is the equal but opposite requirement for generators and suppliers to hedge future revenues that drives forward contracting activities.

Local market power

The Discussion Paper pays special attention to local market power concerns, concluding that “mitigating local market power that might arise in the balancing market is ... an important area to focus on.” (page 17).

However, as NERA have pointed out¹²:

“...conditions in the I-SEM suggest that it may be wrong to focus on market power in the physical markets. Because of the peculiar status of ESB, market power in forward markets can act as a constraint on competition in the physical markets...”

And as NERA further explain¹³:

¹¹ There is possibly one other company operating in I-SEM with a level of fuel diversity and base-load, mid-merit and peaking generating units that could offer a similar advantage.

¹² NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, page 10.

“... [T]he system operator’s concern about transmission constraints and abuse of local market power is likely to prove a secondary issue from competition policy. One of the SEM Committee’s proposed principles is that the market power mitigation mechanism should allow competitive entry and exit, which relies on efficient signals being sent to market participants about the local value of electricity. As a result, it would also be a mistake to try to address transmission constraints using methods that limit the local price of electricity in constrained areas (such as such as bidding rules for the affected generators, if feasible under the new arrangements, or contracts that dampen price signals), if they undermine competition or risk-hedging in the wider electricity market.”

Thus whilst it is important to appropriately address local market power concerns in the I-SEM balancing market, the primary focus of the market power mitigation workstream must be to appropriately manage the capability of the dominant entity to exert market power across energy, capacity and ancillary service markets in the interest of sustaining conditions that support competition. Care should also be taken to ensure that local market power mitigation measures do not restrict the legitimate commercial activities of participants, undermining conditions for investment, competition and security of supply.

In this context we note the discussion in the recent Markets consultation paper (SEM-15-026) of facilitating the switching out of participant bids in the balancing market timeframe. Energia would caution against such measures, and emphasise that if they were implemented, very careful consideration would need to be given to the objective criteria governing their use to avoid arbitrary regulatory intervention that would undermine conditions for effective competition.

The appropriate geographical market

The market power mitigation strategy for I-SEM should consider the ability of participants to exert market power on the island of Ireland, regardless of whether this market is coupled to the rest of Europe. The reasons for this are explained by NERA in section 2.2 of their report accompanying this response.

In the case of participants who operate in both I-SEM and other coupled markets, care should be taken to ensure that their capability to exert market power in the all-island market is not exercised by their trading behaviours in other coupled markets.

Metrics to measure market power

¹³ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, page 11.

It is essential that the metrics chosen to measure market power are sufficient to capture the market power dynamics prevalent in the all-island market, and therefore careful consideration is required to ensure the appropriate metrics are selected. The most reliable indicator of the capability to exert market power is market share, although we acknowledge that it is unlikely to be a sufficient measure on its own, and therefore may need to be augmented by other metrics (e.g. HHI, RSI, etc.). Energia requests that any metrics used as part of the market power mitigation strategy are applied consistently in relation to objectively verifiable data. Such an approach will limit regulatory risk (regulatory discretion in the application of measures) and ensure mitigation measures adapt to changes in the underlying market structure, or prevailing market conditions, that may change all-island market power dynamics.

The need to address market power as it presents itself

The market power mitigation strategy must address market power issues as they present themselves and therefore should not rely on data that is demonstrably unrepresentative of current trends, or try to anticipate what market power capabilities an entity may have under certain contingent circumstances, or during arbitrarily specified future periods. Any concerns there may be about underlying future market conditions can be adequately addressed by implementation of appropriate metrics to measure market power that can be objectively applied, and by inclusion of sunset mechanism based upon objective triggers defined in relation to such metrics. Energia would note that NERA have referred to arguments supporting a forward looking assessment of market power as irrelevant and misleading. Please refer to section 3.3 of the NERA report accompanying this response for details.

Market power mitigation in other markets

Energia welcomes the fact that the RAs are investigating approaches taken to market power mitigation in other markets. Effective mitigation of market power, however, requires careful attention to the specific conditions of the individual market (i.e. its physical structure, ownership, market rules, etc.). As NERA state¹⁴:

“... [W]e would stress the need to assess the impact of proposed MPM Measures in local market conditions. Even transparent and efficient measures that have proved effective and non-distortionary elsewhere may not be useful in the all-island market. Similarly, observing that a particular market functions well in some other jurisdiction is no guarantee that it will function efficiently without MPM measures in all-island conditions. Detailed consideration of all-

¹⁴ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, page 15.

island conditions will be required to avoid both over- and under-regulation of competitive markets.”

Therefore Energia would emphasise that careful consideration is required to ensure that selected measures are appropriate to address the specific nature of the market power issues manifest in the all-island market.

Non-asset backed traders

Non-asset backed traders would be welcome in the SEM / I-SEM forward market but are unlikely to be able to participate in a meaningful way under current conditions because they would be unable to manage their commercial risks and therefore would be subject to large commercial exposures. This is because the current SEM forward market is illiquid and characterised by a “super dominant” participant that remains largely unregulated in forward timeframes. The key to promoting non-asset backed trading, therefore, is the provision of a sufficient level of forward market liquidity that facilitates adequate management of commercial risk. An essential part of delivering this is the effective mitigation of the capability of the dominant entity to exert market power in forward timeframes. Energia would also emphasise that any barriers to forward market trading, including collateral and legal contracting, should also be minimised to facilitate entry.¹⁵ Energia therefore concludes that non-asset backed trading is unlikely to be the solution to low levels of forward market liquidity but may be a further positive side effect of its provision.

Market power concerns in relation to the CRM

Energia observes that reliability options will not address the risk of anti-competitive price suppression in I-SEM energy markets. We also note that the Discussion Paper does not acknowledge the market power issues associated with implementing reliability options in the all-island context. This is a major omission. As a study,¹⁶ co-authored by Professor Ignacio Perez-Arriaga, the former Independent Member of the SEM Committee, states:

“[T]he Achilles’ heel of the reliability options scheme is the potential for market power that can appear in the capacity auction...The workability of the mechanism depends critically on the ability of the auction to attract several potential new entrants and on the role of the incumbents.”

To mitigate against anti-competitive price suppression in the I-SEM capacity market a floor price could be implemented. Energia would suggest the floor

¹⁵ For extensive, constructive suggestions on how forward market liquidity could be promoted under SEM / I-SEM arrangements please refer to our response to the Forwards and Liquidity Discussion Paper SEM-15-010.

¹⁶ IIT Working Paper ‘A Regulatory Instrument to Enhance Security of Supply in the Spanish Wholesale Electricity Market’, March 2006’, page12 (available online: http://www.hks.harvard.edu/hepg/Papers/IIT_Supply_Security%20_0306.pdf)

price could be set equal to a BNE benchmarked calculation. In the absence of a price floor, targeted ex-ante bidding rules on the state-owned incumbent could be considered.

Market power concerns in relation to the ancillary services market

Energia welcomes the recognition by the RAs of the increased risk of exertion of market power in the ancillary service market for products selected under a 'competitive' mechanism and we suggest implementation of a floor price. Similar to the I-SEM capacity market, Energia would suggest the floor price could be set equal to a BNE benchmarked calculation. In the absence of a price floor, targeted ex-ante bidding rules on the state-owned incumbent could be considered. Energia would add that the need for mitigation measures in this area depends upon the criteria used to determine whether sufficient competition in a product exists to support an auction based approach. We would therefore welcome clarification of these criteria.

Benefits of a holistic approach to market power mitigation

To ensure that the intricacies of the market power dynamics between energy, capacity and ancillary service markets are carefully considered (e.g. the ability of the dominant entity, to transfer advantages obtained through exertion of market power in one market to another), Energia recommends that the market power mitigation workstream should encompass all market revenue streams. Energia would therefore welcome further clarification of why the decision to restrict the remit of the market power mitigation workstream to only the energy market has been taken. We are concerned that a major factor driving the decision may be the contracted project timelines,¹⁷ rather than the best interests of consumers.

¹⁷ Please cross reference the concerns raised in relation to unrealistic project timelines in our response to the Markets consultation paper submitted to the SEM Committee on 5th June 2015.

3. Response to Discussion Paper questions

Energia provides responses to the specific questions raised in the I-SEM Market Power Mitigation Discussion Paper below. These are not stand alone answers and must be read in conjunction with this response as a whole.

Question 1

Are the market power concepts and examples provided appropriate and sufficient for I-SEM?

Energia agrees with the view of the RAs that the key consideration in relation to market power mitigation is whether a participant has the capability to exert market power. The dominant state-owned incumbent has extensive capability to exert market power across all energy, capacity and ‘competitively’ selected ancillary services markets under I-SEM and DS3 trading arrangements. The primary focus of the market power mitigation strategy for I-SEM should therefore be to deal with its capability to exert market power.

Energia also agrees with the view of the RAs that *“a generating company with market power might also have the ability and incentive to foreclose competition in other ways; for example by weakening existing competition, raising entry barriers or slowing competition.”*¹⁸ This is a major concern in the all-Island market. It is also vital to recognise however that market power in the all-island context is as likely to be exercised for non-commercial reasons, given the state ownership of the dominant incumbent, which would be equally detrimental to competition. This is an important omission in the Discussion Paper.

As NERA comment¹⁹:

“Because of ESB’s position as a (large) state-owned enterprise, it will be necessary to consider the possibility of ESB using its market power to achieve political objectives, rather than to raise its profits. As a state-owned company, ESB may not operate with entirely commercial objectives. For instance, it may come under pressure to lower energy prices, leading to predation, or it may be driven by management objectives to maintain or expand its market share, even when it would be unprofitable to do so.

However desirable such behaviour may seem from a political point of view, it would be inimical to competition and need not operate in the interests of all electricity consumers. The assessment of ESB’s market power and the design of MPM measures should not therefore be limited to actions that would raise ESB’s profits. The SEM Committee should consider a wider range of possible

¹⁸ See page 6 of the I-SEM Market Power Mitigation Discussion Paper SEM-15-031.

¹⁹ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, page 10.

actions that would harm competition, including actions intended to lower prices (temporarily at least) and/or increase ESB's market share."

The recognition of the potential for exertion of market power in the forward contract market is also welcomed by Energia, and we agree with the sentiment of the RAs that it is *"essential that wholesale prices be free of untoward market power both to control physical spot prices and to ensure competitively priced financial hedges are available to suppliers in terms of forward products and contracts."*²⁰ We would however expand this concern to also include undermining competition by expanding market share beyond what is commercially optimal and concerns regarding predatory pricing activities in the capacity and DS3 markets. We acknowledge the latter issues are out of scope of the market power mitigation workstream as currently defined, and we discuss our views on the decision to limit the remit of the workstream in our answer to question 4 below.

Energia would also emphasise the risk posed to competition by information asymmetry under 'competitive' mechanisms, and the capability of the dominant incumbent to implement portfolio bidding strategies under I-SEM and DS3 trading arrangements (see paragraph 2.2.2 of the Discussion Paper). These risks are not mitigated by implementation of unit based bidding and therefore Energia would request that careful consideration be given to these issues under the market power mitigation strategy.

As a final comment, Energia considers the practice of "financial withholding", to be characterised by a dominant entity increasing prices to a level above what a non-dominant participant can afford to pay, thereby financially withholding the offered volume from its competitors. This practice could create the illusion of liquidity if a dominant entity, engaging in such practices, were selling volumes between its ring-fenced generation and supply companies.

Question 2

Are the potential constraints on market power referred to in [section 2.2 of the Discussion Paper] appropriate for I-SEM?

In the context of the all-island market, Energia emphasises that the potential for exercise of market power in the forward timeframe is not less than in the physical spot market because of the "super dominant" position of ESB in forward timeframes.²¹ Furthermore, the ability of suppliers ("demand") to respond to the exertion of market power in the I-SEM forward market is negligible. This is because remaining unhedged would expose suppliers to

²⁰ See page 6 of the I-SEM Market Power Mitigation Discussion Paper SEM-15-031.

²¹ See Figure 3 on page 16 of the Discussion Paper and the definition of "super dominant" provided by NERA on page 7 of the report accompanying this response.

price volatility in the spot market (e.g. commodity price shocks, extreme cold weather, low plant availability, high wind, etc.), while hedging underlying commodities, as an alternative to purchasing forward contracts, leaves them exposed to fuel basis risk.²² Neither of these alternatives are therefore sustainable options and Energia therefore emphasises that the constraint referenced in paragraph 2.2.3 of section 2.2 of the Discussion Paper does not bind in the context of the all-island market, and that the caveat expressed in paragraph 2.2.5 does apply (i.e. suppliers must purchase forward contracts and therefore “willingness to pay” will not act as a sufficient constraint on the capability of the dominant player to exert market power in the forward market). As NERA observe²³:

“The Discussion Paper ... argues primarily that the forward market will right itself if market power is mitigated in the spot market, as long as market participants arbitrage the two (‘can choose not to contract at a price that is above their expectations of the spot price’). However, it also recognises that market power can be exercised separately in the forward market, specifically if suppliers ‘need to buy forward hedges to reduce the risk of exposure to the volatile physical spot market’. ...

...In practice ... the caveat recognised by the SEM Committee remains a cause for concern – suppliers do need to buy hedges to reduce their risk exposure and would be vulnerable to any exercise of market power.

...The need to hedge risks by buying electricity forward creates an opportunity for the exercise of market power when suppliers are faced with a larger vertically integrated incumbent that is less risk averse or has less need to manage risks. That incumbent can exploit the demand for hedges to raise the premium at which forward contracts trade above expected spot prices (whether or not the spot price is set competitively).”

With regards to the discussion on the form of contracting in the I-SEM forward market, presented in paragraph 2.2.4 of section 2.2 of the Discussion Paper, please cross reference our answer to question 10 below, where we point out that the primary barrier to entry for non-asset backed traders is low liquidity, not the form of forward contracting. Energia has consistently maintained that physical contracting and self-scheduling would significantly reduce barriers to forward market entry, and provide additional forward market liquidity, by removing scheduling risk from the I-SEM energy market design. This in turn would expand the number of thermal generating companies in I-SEM that could participate in the forward market, providing some mitigation of the capability of ESB to exert market power in that timeframe.

²² Sources of fuel basis risk are any spot market price drivers that are not related to underlying commodity prices.

²³ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, pages 12-13.

Energia would also emphasise that the constraints on market power presented in paragraph 2.2.6 of section 2.2 of the Discussion Paper do not bind if the motivation for exerting market power is to foreclose competition. If the dominant party is capable of engaging in non-commercial activity, such as anti-competitive price suppression, or increasing market share beyond what is commercially optimal, then none of the measures (i.e. existing competitors, new potential competition or exertion of buyer power) can mitigate such behaviours. Rather mitigation requires appropriately targeted regulatory intervention.

Energia therefore requests that these considerations are carefully considered as part of the I-SEM market power mitigation strategy to help ensure conditions for effective competition exist under the I-SEM and DS3 arrangements.

Question 3

Given the emerging I-SEM design, including closer integration to European electricity markets and a number of energy trading timeframes, what is the appropriate geographic market(s) and/or trading period(s) definition for the measurement of market power and determination of a mitigation strategy in I-SEM?

In responding to this question Energia has considered it in two parts. Firstly we discuss the appropriate geographical market. Secondly we discuss the appropriate products. Please note that we assume the reference to “trading period(s)” is intended as a reference to all-island markets.

The appropriate geographical market

Consideration of market power under I-SEM and DS3 should focus on the ability of participants to exert market power in the island of Ireland, regardless of whether this market is coupled to the rest of Europe. This position is supported by the rulings of competition authorities and courts. As NERA observe²⁴:

“Competition authorities and courts have repeatedly defined the relevant geographic markets for the electricity sector as national or sub-national, due to the observed constraints on trade between national markets.”

And again:

“In practice, even where markets are already coupled, the Commission has repeatedly defined the relevant electricity wholesale market as national or sub-national, in large part due to the presence of physical constraints and congested interconnectors.”

²⁴ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, pages 3.

This is because the presence of physical constraints on interconnectors allow for price divergence to occur, and therefore the existence of a local market.

As NERA conclude²⁵:

“Trading arrangements within the Irish all island electricity market may in future be coupled with those in the electricity market in Great Britain. More efficient coupling may, at different times increase both imports (i.e. supply), and exports (i.e. demand) in the I-SEM, with multiple and variable effects on the level of competition. These effects may merit further analysis. However, market coupling will not overcome the physical constraints on trade between these two geographic markets. Any hypothetical monopolist might be able to raise prices in Ireland without fear of being undercut by competitors from Great Britain. The persistence of such physical constraints implies a geographic market definition that is limited to the island of Ireland, suitably adjusted for the additional supply and demand from interconnectors. However, to reach a final answer, this aspect of market definition requires more detailed analysis, using objective evidence on supply and demand conditions.”

In the case of participants who operate in both I-SEM and other coupled markets care should be taken to ensure that their capability to exert market power in the island of Ireland is not exercised by their trading behaviours in other coupled markets. This may require co-operation with other regulators (e.g. Ofgem) to facilitate analysis of how their activities in other coupled markets affect flows on I-SEM interconnectors and therefore local I-SEM dynamics.

The appropriate definition of products (I-SEM and DS3 markets)

The market power mitigation strategy must effectively mitigate the market power of the dominant player across all energy (spot and forward), capacity and ‘competitively’ selected ancillary services products to provide market conditions that support effective competition under I-SEM and DS3. The capability of the dominant state owned incumbent to exert market power across all markets, and its potential negative consequences for competition, was discussed earlier in this response.

Furthermore Energia would draw particular attention to the need to mitigate the capability of the dominant state owned incumbent to exert market power in the forward contracts market where it has an 85% market share. This is considered under competition policy to be a “super dominant” position (see section 3.2 of the NERA report accompanying this submission), and without appropriate mitigation measures could significantly undermine the conditions

²⁵ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, pages 4.

for retail competition under SEM and I-SEM trading arrangements. This is discussed in more detail in our response to question 7.

In the absence of any meaningful divestment of ESB assets, Energia would emphasise that it is only by maintaining and promoting competition that the fundamental market power issues that persist in the all-island market can be addressed.

Question 4

Are the various (other) market design issues referred to in [Section 2.3 of the Discussion Paper] and their potential impacts on market power captured appropriately and fully?

Energia provides its views on the potential impacts of the emerging I-SEM and DS3 market designs on market power within the all-island context below.

Market Zone: Assuming that the flows on SEM interconnectors are currently sub-optimal, and the dominant flow is an import to SEM, it is not necessarily the case that optimisation of flows (which will result presumably in more exports) will increase competition in the island of Ireland – please see the discussion on the appropriate geographical market in our response to question 3 above.

Trading Day: Energia does not believe aligning the I-SEM trading day to other European markets has any material effect on the capability of dominant entities to exert market power in all-island markets and the rationale for this assertion is not explained in the discussion paper.

Trading Period: We observe that, if the intra-day trading period in I-SEM is hourly and therefore does not facilitate effective shape management, then it may have less of a commercial impact on ESBPG compared to other participants because of their ability to offset imbalance exposures across their large generation portfolio.

Gate Closure: The shorter period between gate closure and delivery mean that the dominant state owned incumbent can increase its potential market power as the TSO will rely more on flexible generation, c46% of which is owned and operated by ESBPG, including OCGTs, hydro, pumped storage and peaking units.

Offers / Bids: Energia would note that I-SEM offer formats in the energy market will introduce a degree of subjectivity into risk management choices by generators. Combined with the additional complexity of the trading arrangements (i.e. the increased number of markets), this will make monitoring and detecting abuse of market power more difficult. Furthermore, the ability of demand to actively participate allows for the potential exertion of market power on the demand side of the market.

Market Clearing Timeframes: Energia would again emphasise the significantly more complex I-SEM and DS3 trading arrangements, which will make monitoring and detecting abuse of market power more difficult than under the current SEM arrangements.

Firm Pricing: As discussed above, the additional complexity of I-SEM and DS3 trading arrangements will make it more difficult to monitor and detect market power. We do not believe firm pricing will substantially alleviate this concern or limit the capability of the dominant incumbent to exert market power (e.g. under the I-SEM energy market design the capability will exist for it to influence price via both the buy and sell side of the market).

Forward Contracts: Energia greatly appreciate the inclusion of the forward contract market under the remit of the market power mitigation workstream. Experience from the SEM indicates that the “super dominant” position of the state owned incumbent in this market means that mitigating its market power in the spot market is not sufficient to mitigate its capability to exert market power in the forward market. This is discussed in more detail in our response to questions 1, 7 and 10.

Cross Border Settlement: – Please refer to our views on Market Zone above.

Capacity Payment: Leaving aside issues regarding the appropriate reference market for reliability options, and the fact that reliability options will not address predatory pricing behaviours in energy markets, Energia notes that the market power issues associated with implementing reliability options have not been considered. We believe this is a major omission. As a study,²⁶ co-authored by Professor Ignacio Perez-Arriaga, the former Independent Member of the SEM Committee, states “[T]he Achilles’ heel of the reliability options scheme is the potential for market power that can appear in the capacity auction...The workability of the mechanism depends critically on the ability of the auction to attract several potential new entrants and on the role of the incumbents.”

Ancillary Services: Energia welcomes the recognition by the RAs of the increased risk of exertion of market power in the ancillary service market for products selected under a ‘competitive’ mechanism. We would therefore welcome further information on the criteria that will be used to assess the suitability of implementing ‘competitive’ selection processes in this market.

Local Market Power: Energia would emphasise that, while it is important to appropriately address local market power concerns in the I-SEM balancing

²⁶ IIT Working Paper ‘A Regulatory Instrument to Enhance Security of Supply in the Spanish Wholesale Electricity Market’, March 2006’, page 7 (available online: http://www.hks.harvard.edu/hepg/Papers/IIT_Supply_Security%20_0306.pdf)

market, the primary focus of the market power mitigation workstream must be to appropriately manage the capability of dominant state owned incumbent to exert market power across energy, capacity and ancillary service markets in the interest of sustaining conditions that support competition. Energia would also stress that care be taken to ensure that local market power mitigation measures do not restrict the legitimate commercial activities of participants, undermining conditions for investment, competition and security of supply. In this context we note the discussion in the recent Markets consultation paper (SEM-15-026) of enabling market systems to facilitate the switching out of participant bids in the balancing market timeframe. Energia would caution against such measures to avoid arbitrary regulatory intervention that would undermine conditions for effective competition, given the difficulty of defining objective criteria governing their use. These issues are discussed in more detail in our answer to question 9 below.

As a final comment, Energia would request that the market power mitigation strategy deals carefully with the interactions between markets and not just the conditions in any one market. It must also give due consideration to the status of ESB as a state owned company who, as identified by NERA²⁷: “ ... *may not operate with purely commercial objectives ...[and] ... may come under pressure to lower energy prices, leading to predation, or ... may be driven by management objectives to maintain or expand ... market share, even when it would not be profitable to do so*”. These concerns emphasise the importance of ensuring the market power mitigation strategy removes the capability of ESB to exert market power to help ensure the conditions for effective competition are not undermined under I-SEM and DS3. In the absence of any meaningful divestment of ESB assets, Energia strongly emphasises that it is only by maintaining and supporting the conditions required for competition that the fundamental market power issues that persist in the all-island market will be addressed.

As discussed in section 2.3 of this response, Energia is concerned that the disparate approach to market power mitigation proposed in the discussion paper could make it more difficult for the RAs to effectively manage these more subtle considerations. Furthermore, that a major factor driving the decision not to include capacity and ancillary services under the market power workstream may be the contracted project timelines,²⁸ rather than the best interests of consumers. We would therefore welcome further clarification on the rationale behind this decision.

²⁷ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, page 10.

²⁸ Please cross reference the concerns raised in relation to unrealistic project timelines in our response to the recent Markets consultation paper (SEM-15-026) submitted to the SEM Committee on 5th June 2015.

Question 5

What is the appropriate approach to measuring market power when developing a mitigation strategy for I-SEM?

Energia considers the most reliable indicator of the capability to exert market power is market share, although we acknowledge that it is unlikely to be a sufficient measure on its own, and therefore may need to be augmented by other metrics (e.g. HHI, RSI, etc.). Regardless of the metrics used, however, Energia would emphasise that results for the all-island market will indicate the need to mitigate the extensive capability of the state owned incumbent to exert market power. As NERA observe²⁹:

“Typically, competition authorities: (1) assume that market participants may have a dominant position if they possess market shares above 40 per cent, (2) presume that market participants do have a dominant position if they possess market shares above 50 per cent; and (3) presume that market participants are “super dominant” if they possess market shares above 80 per cent.

The market shares presented by the SEM Committee show that, by these standards, ESB has a share that would be consistent with a dominant position in installed capacity and super dominance in Contracts for Difference (see the figure on page 15 of the Discussion Paper). If the SEM Committee were to adopt narrower market definitions by geography or by period of delivery, ESB’s market shares in those segmented markets might increase further. Moreover, ESB has the largest market share in both generation and supply segments and has three times as much capacity as its competitors by any measure presented in the Discussion Paper. Thus, all the measures of market power suggested by the SEM Committee point towards including ESB in the proposed arrangements for market power mitigation.”

While there is no objective standard for selecting appropriate metrics for measuring market power it is essential that the metrics employed under the market power mitigation strategy are sufficient to capture the market power dynamics present in the all-island market. Furthermore, care should be taken to ensure the selected metrics do not result in the unnecessary application of mitigation measures to participants that do not have the capability to exert market power. As NERA observe³⁰, unnecessary application of mitigation measures could undermine the conditions required to support competition:

“The results of applying these methods [i.e. market power metrics] should be credible in all island conditions, but should not extend MPM Measures further than necessary, to avoid stifling competition.”

²⁹ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, page 7.

³⁰ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, page 9.

As discussed in our response to question 7 below, the market power metrics in the current SEM are insufficient to capture the “super dominant” position of ESB in the forward contract market. This is because the current market power mitigation strategy for the SEM is focused on mitigating market power in spot timeframes, and does not consider market share in the forward market. It is important that the market power mitigation strategy for I-SEM therefore addresses this issue.

One approach may be to exclude wind from the HHI calculation applied in the spot market, on the assumption that wind cannot be used to back out forward market sales. Another option, however, may be to carry out two separate HHI calculations, one for the spot market and one for the forward contract market. The level of directed contracts imposed could then be set to manage market power in both of these markets. If the volume of directed contracts required to manage market power in the forward market was greater than in the spot market, then the volume of directed contract could be set at the minimum of the volume required to mitigate market power in the forward market, or a forecast of the dominant entities’ spot market output. The potential drawback of this approach is that it could perversely incentivise the dominant entity to sell less in the forward market to reduce its HHI.

This discussion illustrates the difficulty of selecting appropriate measures and underlines the importance of carefully selecting metrics that are appropriate to address the market power issues present in the all-island market. For similar reasons as outlined above, Energia also request that careful consideration is given to the metrics used to assess market power under capacity and ancillary services auctions.

More generally, Energia requests that any metrics used as part of the market power mitigation strategy are applied consistently in relation to objectively verifiable data. Such an approach will limit regulatory risk (regulatory discretion in the application of measures) and ensure mitigation measures adapt to changes in the underlying market structure, or prevailing market conditions, that may change all-island market power dynamics. As NERA comment³¹:

“To mitigate market power on an ex ante basis, the SEM Committee must define a screening rule for identifying maker power that complies with its principle of transparency (see discussion in chapter 4 below). Accordingly, a combination of measures to identify market power will only fulfil the SEM Committee’s principles, if that combination is applied in a transparent, formulaic way that does not allow room for undue regulatory discretion.”

³¹ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, pages 8-9.

Question 6

Should the measure be determined at a snapshot in time or based on historical or potential future trends in market share (or both or all three)?

Energia emphasise that the market power mitigation strategy under I-SEM and DS3 trading arrangements needs to address market power issues as they present themselves and therefore should not rely on data that is demonstrably unrepresentative of current trends, or try to anticipate what market power capabilities an entity may have under certain contingent circumstances, or during arbitrarily specified future periods. This is because any concerns there may be about underlying future market conditions can be adequately addressed by implementation of appropriate metrics to measure market power, that can be objectively applied, and by inclusion of sunset mechanism based upon objective triggers defined in relation to such metrics. As NERA observe:

“... [R]elying on current or historical data means that any particular set of MPM Measures may cease to be suitable in future. Such outcomes are the inevitable consequence of unpredictable conditions, not the result of “inadequate” forecasts. However, the possibility that market power might reduce in the future provides no excuse for not mitigating market power today, as the RAs can always withdraw MPM Measures that later prove unnecessary. Indeed, the SEM Committee’s own principles acknowledge that such measures can include sunset clauses so that MPM Measures elapse at a defined time or in (objectively) defined circumstances.”

NERA have referred to arguments supporting a forward looking assessment of market power as irrelevant and misleading. As NERA comment³²:

“ESB has advocated using a “forward-looking” assessment to identify market power in the context of the I-SEM. In support of its proposal, ESB cites a previous statement by the European Commission, that National Regulatory Authorities will define relevant markets on a forward-looking basis for the purposes of sector-specific regulation.

However, this statement is irrelevant, and ESB’s argument is misleading ...”

For a full account of NERA’s assessment please refer to section 3.3 of the NERA report accompanying this response.

Question 7

How effective have the SEM market power mitigation strategy and measures been?

³² NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, pages 7.

The SEM market design was proficient at managing market power in the wholesale spot energy market. The market design facilitated a BCoP supported by three part complex offers and guaranteed cost recovery under the pool algorithm. This was combined with a capacity calculation that facilitated recovery of fixed costs, and ancillary services tariffs. The combination of these approaches guaranteed revenue adequacy and therefore ensured that reasonable conditions for effective competition exist under the SEM design. A critical area overlooked by the SEM market power mitigation strategy, however, was the capability to exert market power in the energy forward contract market. We therefore welcome and strongly support the inclusion of this area under the I-SEM market power mitigation workstream.

Energia notes that low levels of liquidity and / or unjustifiably high prices in the SEM / I-SEM forward market could: undermine conditions for retail competition; increase costs to consumers; and may be indicative of the exertion of market power. As Baringa observe³³:

“Historical data and analysis as outlined above indicate a number of issues that restrict liquidity and competition in the SEM forward market. Indicators of restricted liquidity include low trading volumes, wide bid-offer spreads, infrequent trading opportunities and the NDC premia over the DC price. These issues could be regarded as being consistent with the presence of a dominant player with limited incentives to trade in the forward market, to the detriment of competitive pricing and consumer choice.”

And again:

“Analysis of the current SEM forward market indicates exceptionally low levels of market led liquidity and exhibits dynamics that could be indicative of the exertion of market power.” [ibid, page 26]

Mitigating the capability to exercise market power in the forward timeframe is essential to sustain retail competition (i.e. to ensure suppliers can maintain access to hedging products at transparent and competitive pricing levels). Analysis conducted by Baringa indicated an average premium of €2.48/MWh was paid by suppliers for products sold in the SEM NDC market in 2013. Energia notes that the offer premium may have been substantially higher if the analysis had taken into account the fact that suppliers are likely to “cherry pick” the least cost products when trading. The information provided in Figure 7 on page 21 of the Discussion Paper paints a similar picture to the Baringa analysis, clearly indicating that NDC contract offerings have tended to trade at significant premiums to DC pricing levels, despite the risk to ESB of offering

³³ Baringa, ‘I-SEM HLD Consultation: Promoting forward liquidity and mitigating market power in the I-SEM’, 6 April 2014, page 11.

forward contracts being substantially less than other generating companies operating in the all-island. The analysis presented by the RAs in Figures 3, 6 and 7 on pages 16, 20 and 21 of the Discussion Paper would therefore seem to provide further evidence to support Baringa's conclusions. In the interest of putting in place the conditions required for retail competition, Energia therefore requests that mitigation measures that remove the capability to exert market power in the SEM / I-SEM forward contract market be implemented as soon as possible.

Question 8

To what extent is the strategy and measures applicable to I-SEM?

Transferal of the SEM market power mitigation strategy to I-SEM and DS3 trading arrangements is not feasible because of the significantly more complex energy trading arrangements, and the decision to implement 'competitive' mechanisms in capacity and ancillary services markets. The SEM market power mitigation measures were appropriate in the context of the underlying SEM market design. Transferal of them to I-SEM and DS3 arrangements would present a significant risk of restricting the legitimate commercial activities of non-dominant entities, undermining the conditions for competition further increasing the dominant entity's market power, as opposed to mitigating it, and therefore should be avoided.

Energia therefore requests that the I-SEM market power mitigation workstream, and other I-SEM and DS3 workstreams dealing with market power issues, focus on the development of an appropriate and effective market power mitigation strategy that works within the context of the I-SEM and DS3 trading arrangements. As NERA comment³⁴:

"There is a fine line between protecting competition and stifling competitive behaviour. Any final decision on Market Power Mitigation Measures (MPM Measures) will need to demonstrate that the measures are applicable to all-island conditions and that they will not unduly hamper normal competitive behaviour. MPM Measures cannot merely be copied from other markets."

Question 9

Are there other market power mitigation measures worth considering in the context of I-SEM? (See Appendix 2 for a review of a number of other European markets).

Energia welcomes the fact that the RAs are investigating approaches to market power mitigation in other markets. Effective mitigation of market power, however, requires careful attention to the specific conditions of the

³⁴ NERA, 'Review of Market Power Principles for I-SEM', 18 June 2015, pages 9.

individual market (i.e. its physical structure, ownership, market rules, etc.). This is particularly the case in the context of the SEM / I-SEM because of the continued presence of ESB as the large, legacy state owned incumbent in relatively small retail and wholesale markets. Therefore careful consideration is required to ensure that mitigation measures implemented are appropriate to address the specific nature of the market power issues that manifest themselves in the all-island context. As NERA comment³⁵:

“ ... [W]e would stress the need to assess the impact of proposed MPM Measures in local market conditions. Even transparent and efficient measures that have proved effective and non-distortionary elsewhere may not be useful in the all-island market. Similarly, observing that a particular market functions well in some other jurisdiction is no guarantee that it will function efficiently without MPM measures in all-island conditions. Detailed consideration of all-island conditions will be required to avoid both over- and under-regulation of competitive markets.”

Nevertheless, Energia believes there may be merit in the I-SEM market power workstream considering the approach to local market power implemented in the BETTA market. Such an approach would have limited impact on central systems, other than the need for transparent reporting of market information, and could accommodate the principle of revenue adequacy when considering if local market power was being exercised. Energia considers this to be an essential consideration under the I-SEM and DS3 trading arrangements as explained below.

If a generator does not secure a capacity contract under the I-SEM CRM, receives minimal revenues from DS3, but is required for system support reasons, then Energia would emphasise that it is perfectly legitimate for that generator to recover both its fixed and variable costs, and achieve a reasonable rate of return, via I-SEM spot energy markets. Therefore, determination of whether local market power is being exercised must take account of the principle of revenue adequacy, to ensure conditions for competition are supported under the market design. As NERA observe³⁶:

“... [T]he system operator’s concern about transmission constraints and abuse of local market power is likely to prove a secondary issue from competition policy. One of the SEM Committee’s proposed principles is that the market power mitigation mechanism should allow competitive entry and exit, which relies on efficient signals being sent to market participants about the local value of electricity. As a result, it would also be a mistake to try to address transmission constraints using methods that limit the local price of electricity in constrained areas (such as such as bidding rules for the affected

³⁵ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, pages 15.

³⁶ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, pages 11.

generators, if feasible under the new arrangements, or contracts that dampen price signals), if they undermine competition or risk-hedging in the wider electricity market.”

In this context we note the discussion in the recent Markets consultation paper (SEM-15-026) that market systems facilitate the switching out of participant bids in the balancing market timeframe. Energia would caution against such measures to avoid arbitrary regulatory intervention that would undermine conditions for effective competition, given the difficulty of defining objective criteria governing their use. For similar reasons Energia would not support the implementation of arbitrary price caps in I-SEM spot energy markets, which seems to be an approach that has been adopted in the Spanish day-ahead market. As NERA observe³⁷:

“... we note the importance of maintaining transparency and minimising regulatory discretion, in order to permit effective competition. Vague or arbitrary application of these principles will discourage market participants from acting in a competitive manner, as well as (or instead of) discouraging non-competitive behaviour. The assessment process will therefore need to provide objective evidence for any proposed interventions... .”

Other measures that could be considered are reintroduction of Virtual Independent Power Plants (VIPPs) backed by the generation portfolio of ESBPG. We note that such an approach would provide the opportunity for suppliers to hedge via commodities but may not improve liquidity in the forward contract market.

Question 10

What are the barriers to entry for non-asset backed traders in the SEM financial forwards market?

Energia observes that the primary function of forward markets is to facilitate the management of participant exposures to spot market volatility (i.e. to manage commercial risk).

Non-asset backed traders would be welcome in the SEM / I-SEM forward market but are unlikely to participate under current conditions because they would be unable to manage their commercial risks and therefore would be subject to large commercial exposures. This is because the current SEM forward market is illiquid and characterised by a “super dominant” participant that remains largely unregulated in forward timeframes.

The key to promoting non-asset backed trading, therefore, is the provision of a sufficient level of forward market liquidity that facilitates adequate management of commercial risk. An essential part of delivering this is the

³⁷ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, Executive Summary, page ii.

effective mitigation of the capability to exert market power in forward timeframes. Energia would also emphasise that any barriers to forward market trading, including collateral and legal contracting, should also be minimised to facilitate entry.³⁸

Energia therefore concludes that non-asset backed trading is unlikely to be the solution to low levels of forward market liquidity but may be a further positive side effect of its provision.

Question 11

Are the principles of market power mitigation outlined in this section appropriate?

Energia would refer to the assessment of the principles carried out by NERA in section 5 of the report accompanying this response. We would particularly draw attention to the emphasis placed by NERA on promoting the conditions required for effective competition. In the absence of any meaningful divestment of ESB assets, it is only by maintaining and supporting the conditions required for competition that the fundamental market power issues that persist in the all-island market will be addressed.

Question 12

How should these or other principles be applied in I-SEM?

There is a strong case for implementing targeted measures on the dominant state owned incumbent to mitigate its extensive capability to exert market power across energy, capacity and ancillary services markets under I-SEM and DS3. Targeted mitigation measures would ensure effective management of the dominant entity's market power without undermining the legitimate commercial activities of other non-dominant participants, thereby supporting market conditions for competition. As NERA comment³⁹:

"If ...measures show other market participants do not have market power, the SEM Committee should take care not to include them in a blanket restriction without good reason. It is harmful to competition to design thresholds that include market participants unnecessarily, since Market Power Mitigation Measures ("MPM Measures") can discourage competitive behaviour as well as non-competitive behaviour (see discussion of the principle "enabling competitive entry and exit" in chapter 5 below). In such conditions, it makes sense to extend MPM Measures only to those market participants that appear to possess market power by a number of different measures."

³⁸ For extensive, constructive suggestions on how forward market liquidity could be promoted under SEM / I-SEM arrangements please refer to our response to the Forward and Liquidity Discussion Paper SEM-15-010.

³⁹ NERA, 'Review of Market Power Principles for I-SEM', 18 June 2015, page 7.

Energia also strongly recommends that the impact of market power mitigation measures are carefully analysed with relation to the specific characteristics of the all-island market (i.e. the presence of a dominant state-owned entity who may not have purely commercial incentives, and is active, with considerable market share, on both the supply and demand side of the market). As NERA observe⁴⁰:

“...we would stress the need to assess the impact of proposed MPM Measures in local market conditions. Even transparent and efficient measures that have proved effective and non-distortionary elsewhere may not be useful in the all-island market. Similarly, observing that a particular market functions well in some other jurisdiction is no guarantee that it will function efficiently without MPM measures in all-island conditions. Detailed consideration of all-island conditions will be required to avoid both over- and under-regulation of competitive markets.”

Finally, Energia requests that the market power principles are applied consistently, in a predictable, transparent manner to remove regulatory discretions (regulatory risk) and therefore support conditions required for competition. As NERA comment⁴¹:

“Regarding the ‘key principles’, we note the importance of maintaining transparency and minimising regulatory discretion, in order to permit effective competition. Vague or arbitrary application of these principles will discourage market participants from acting in a competitive manner, as well as (or instead of) discouraging non-competitive behaviour. The assessment process will therefore need to provide objective evidence for any proposed interventions...”

⁴⁰ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, page 15.

⁴¹ NERA, ‘Review of Market Power Principles for I-SEM’, 18 June 2015, Executive Summary, page ii.