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Dear Gonzalo and Joe,

PrePayPower, as Ireland's largest prepay electricity provider, welcomes the opportunity to contribute to the SEM Committee "I-SEM Market Power Mitigation" Consultation Paper (SEM-15-031).

PrePayPower welcomed the high level design of the I-SEM physical energy markets. Every participant is obliged to bring its power generation and consumption to anonymised trading platforms. No direct netting of vertically integrated businesses' power is permitted; all must contribute to price formation in transparently accessible markets. There are clear market benefits regarding the management of market power with such a design, which in effect is a form of vertical-ring fencing for all participants within the physical energy markets. We believe that these principles should continue to be reflected in a SEM Committee supported forwards market.

For PrePayPower, the market power consultation focusses on the market prices arising within the physical markets, and the impact of vertical ring-fencing and directed contracts have to reduce the potential opportunities to exercise market power. This element of the consultation is appropriate and welcome. We provide views on our preferences for bidding controls in the responses to the specific questions raised by the paper. We agree that controls must become more strict as real-time approaches (due to the narrowing of the market size), and favour ex ante rules that are monitored ex post by the MMU. We are not in favour of ex post interventions in the balancing market. We also believe that the SEM Committee should retain and describe the power to mandate participation in ex ante physical markets should the need arise, as per the High Level Design decision.

**This consultation paper does not, however, focus on the accessibility and liquidity of risk management tools in the forwards market. The forwards market has been considered less likely to be subject to market power by the SEM Committee, and more of a matter for the financial regulator. We believe this is a fundamental oversight. Without readily available risk management tools, there is little hope for**



**structural sustainable new entry in the retail market. Without sustainable new entry, market power will continue to endure.**

Where physical access to the Grid is limited for conventional generation, development of a vertically integrated business to manage risk at the retail level is difficult. Non-vertically integrated businesses must rely on participants who may be long on generation – who are also competitors in the retail market – to offer hedges on competitive terms. Market power can therefore be exercised not only through manipulation of market prices, but also in the creation of barriers to entry by withdrawing access to risk management tools.

Utility traders should have a range of hedging products available to them to regularly take and unwind forward positions, working with counterparties backed off with physical assets and financial positions. Given the small nature of the all-island market, the added complexity of the I-SEM (i.e. Reliability Options, multiple physical markets), and no firm regulatory commitment to the development of standard forwards products in a public market, PrePayPower fears that financial traders may not materialise as credible risk management partners.

This is an acknowledged issue in the SEM. The SEM's gross mandatory pool, however, where every supplier faces the same energy prices based on short-run marginal cost, has allowed new retail entry despite this issue, supported by low volatility in fuel prices (with one or two notable periods of exception). A combination of market power controls (bidding code of practice), simple market design, and an element of luck has allowed this forwards market issue to remain largely unresolved.

The I-SEM, however, is no SEM. It is a more complex market, with new signals to be balance responsible. Indeed, the CRM design has recognised this issue, with the protection afforded by the Reliability Option against peak prices in all timeframes (subject to the resolution of the "hole in the hedge").

To that end, PrePayPower requests:

- The forwards market should be based on regulated principles as consistent as possible with the physical markets, requiring generation to offer hedging to the forwards markets;
- This implies vertical ring-fencing not only for the ESB, but also for all vertically integrated utilities;
- Prices offered should be subject to the same oversight as the physical markets, noting that the controls will be less strict the further out from real-time delivery the product traded is; and
- The SEM Committee should support this regulation with development of a standardised forward market place and products, consistent with the Reliability Options and the high-renewable penetration that creates volatility in all generators' physical positions, while minimising collateral requirements across all market timeframes.

To reiterate, liquid forwards markets are required to manage pricing risk. Risk management is important for sustainable new entry on both sides of the market, which is the only tool available to address structural market power issues. It is not sufficient to consider the forwards market in isolation of its wider importance for competition.



We have responded briefly to the specific questions raised in the discussion paper below.

Our response is not confidential and may be published in full. If you wish to have further communication in relation to our submission, please don't hesitate to contact me.

Yours faithfully,

Cathal Fay



## Section 2

*Do you agree with the policy developments and trends identified (above) as potentially impacting on an I-SEM market power mitigation strategy?*

*Are there other factors not identified here which you consider relevant?*

We agree that increased Interconnection, demand side response, and the new introduction of the DS3 market to support increased renewables, added to the overall market design address the policy development and market trends in the assessment of market power.

We also note, however, the potential for sale of organisations in the market to either an existing SEM or European player, which could create rapid change in the overall structure of the market. We suggest that market power regulatory regimes should therefore be adaptable to such sale events.

PrePayPower contends that market power in the I-SEM is more related to forwards market liquidity than the consultation paper draws out. By means of contrast, lack of liquidity in hedging is recognised as a competitive issue in the SEM Committee's own paper where they view Reliability Options as a mechanism to provide peak price hedges for all suppliers. Lack of liquidity is a competitive issue that undermines the gradual structural change of the market with sustained new entry. This link between liquidity, gradual structural change in the market is not discussed within the paper.

Specifically, by having the potential to deny power contracts to the market there is the possibility for larger players to drive smaller players from the market, further enhancing their own market power.

The consultation paper appears to seek to manage market power as a non-resolvable issue. The evaluation of proposed market power mitigations under the "efficacy" criterion excludes structural impacts, i.e. the impact on market entry and exit.

## Section 3

*Do you agree with the proposed appropriate markets/trading periods for assessing market power in I-SEM's energy and financial markets?*

*Do you agree with the proposed geographic scope of the proposed markets/trading periods?*

We agree with the identification of the markets and their timeframes. We do think that there is a difference in the definition of the geographic market due to the nature of coupling in the DAM and IDM, relative to the BM. We are uncertain whether "including the Interconnectors" refers to the physical assets themselves, the power that can be represented through them from European Trading Platforms, or the amount of capacity held back by the TSO for TSO-TSO trading.



## Section 4

*Do you agree with the proposed definition of competitive behaviour and pricing in I-SEM?*

*Do you think that the suggested examples in which market power can be exercised in I-SEM captures the relevant issues?*

*Do you agree that the potential for market power abuse in I-SEM appears to be weaker in the forward financial market compared to the physical markets?*

*Do you agree with the implications for market power arising from interactions between the physical markets, CRM, FTRs and DS3 System Services as shown above?*

We, in general, agree with the theoretical analyses within the paper, including the proposed definition of competitive behaviour, and the forms of exercising market power.

We agree that the potential for abuse in the forwards market is lower, but we also note that the vast majority of the forwards contracts only exist due to regulatory considerations (DCs, PSO Auctions, etc.). There are no other market power mitigations for the forwards market, as activity in it is so low.

The forwards market, therefore, fails the basic test of whether the market is performing adequately (it is illiquid). There is uncertainty as to why that is. The SEM Committee have argued that it is less likely to be a structural issue than those identifiable in the physical markets. There is no statement or analysis as to whether this is a conduct issue, other than there is no “significant, ongoing” evidence of withholding.

In summary, the forwards market is identified as dysfunctional, its relevance to improved competition ignored, and no action is taken all within the context of a market power paper which recognises a lack of competition. As noted earlier the potential here is for smaller players to be driven from the market concentrating market power further and leading to a market lacking liquidity and transparency.

The discussion of interactions between CRM, FTRs and DS3 system services is at a very high level. Further review will be required to examine these interactions and adequately capture gaming behaviour within the market power metrics.

## Section 5

*Do you agree that these are the appropriate metrics to identify market power ex-ante and ex-post in I-SEM?*

*Are there other metrics that you consider should be applied?*



We strongly support the concept of analysis structure, conduct and performance across all market timeframes, and that the metrics which fall out are appropriate. The key metric which we believe to be under-developed for generators is the Net Revenue measurement. It should consider the implications of increased revenue under FTRs, DS3 and CRM within its remit, and not just energy margins.

## Section 6

*Do you agree with the approach taken by the RAs to modelling market power in I-SEM?*

*Do you agree with the conclusions for I-SEM market power that have been drawn from the modelling results?*

With the introduction of the I-SEM, there will need to be a material level of forward contracting of renewable generation with utilities, and this renewable generation will be able to influence price in the DAM and IDM. The REFIT PSO Order can provide some indication of the various market shares. This should be taken into account within the analysis.

We note the potential for sale of market participants over the timeframe between now and I-SEM go-live.

We have no objection, noting the comments above, to the findings of the analysis.

We were very concerned in some of the meetings on Market Power mitigation that “*due to the increased nature of wind generation hedges for the whole market could not be offered*”. PrePayPower strongly believe that it is imperative for all generators and suppliers, regardless of fuel type to offer all their volume through CfDs in a forward market.

## Section 7

*Do you agree with the SEM Committee’s view on the effectiveness of each of the SEM market power mitigation measures?*

*Are there any particular aspects of the SEM market power mitigation strategy that you think should be applied differently, especially in relation to I-SEM?*

We agree with the SEM Committee’s assessment of the market power mitigation measures.

We believe ring-fencing of ESB should not be reduced, and indeed the concept expanded to more participants to bring more liquidity into the forwards market.



## Section 8

*Do you agree with the five key principles for assessing market power mitigation policies as outlined in this section 8.3? If you think there should be alternatives, please state the reasoning.*

We note that the Effective principle only deals with looking at performance and conduct within the status quo of the existing market. It does not examine the potential structural changes that may arise from the intervention – or lack of intervention – in a particular market.

In particular, we have concern (consistent with the concerns noted above) that the forwards market remains somewhat of an orphan child within the programme. Market power – which currently drives the most liquidity in the market – now also appears to be assuming that it is a matter for not only another workstream, but a different regulator.

We believe that forward market obligations not only meeting the five criteria as stated, but also remove a barrier to structural changes to competition – i.e. the difficulty in achieving grid access to compete as a vertically integrated utilised.

*For the Forward Contracting Obligation: - What should be the measure and threshold that results in a market participant being included or excluded in the FCO, i.e. what is its applicability? - What should be the volume and product definition of forward contracting required from a market participant who falls under the FCO? - How should the price be set for the volume contracted under the FCO? - What type of access should buyers have to FCO volumes?*

We believe that the FCO should extend to all generation in the forwards market. Like the physical DAM, IDM, BM, there should be rule-based structural separation of generation and supply activities, bringing all traded risk management tools into a single, anonymised risk trading platform.

We believe that with vertical ring-fencing applied throughout the market, and standardisation of forwards contracts against the DAM, this will effectively drive a FCO in the physical market without the need to define thresholds or prices. All buyers and all sellers must have free and equal access to the same prices and volumes in forwards market. For vertically integrated utilities there must not be an internal price and volume and an external price and volume.

*Which of the balancing market mitigation options do you consider most appropriate, i.e. MMU-triggered intervention, automated intervention via a PST or via the “flagging and tagging” approach, or prescriptive bidding controls? Where feasible please relate the preferred approach the five key principles for this workstream of effective, targeted, flexible, practical and transparent.*





MMU triggered intervention is the least favourable. Traders will be reacting to potential BM pricing through IDM trades. If BM prices are changeable based on human judgement after the fact, this may lead to otherwise prudent IDM trades becoming substantially loss making.

Both the Pivotal Supplier Test and Flagging and Tagging involves replacing (with some degree of dynamic in the decision making) participants' balancing market offers with regulated bids. The question is whether these activities are predictable by trading participants within the IDM timeframe. Flagging and Tagging remains under development under the rules liaison group, and until the predictability of that process is understood in practice, it is difficult to support changing BM offer through this option at this time. To do so would be to proceed blindly. The PST may be workable as long as the identification of generators with market power is managed stably, i.e. a generator's status for a given balancing market timeframe is known before that IDM opens for that trading period, and does not change until that trading period has passed. With those forms of restrictions, the PST becomes closer to negotiating a contract which includes obligations in relation to an energy bidding strategy for a generator which has medium-to-long term market power. This aligns better with the TSO contracting long-term for generators who may be required to resolve constraints, rather than a PST that is run from day-to-day.

We believe that MMU intervention and flagging and tagging approaches are not sufficiently targeted. They will impact IDM bidding behaviours.

We believe that the PST is not particularly practical, being complicated and with effects that can be replicated for local market power with long-term contracting of constrained generators. It also appears overly targeted – if we understand the approach correctly – to generators with local market power. It does not appear sufficient, by itself, to manage market concentration issues.

Overall, therefore, we support tight bidding principles in the BM, requiring demonstration of short-run marginal cost bidding in the BM, with regulated scarcity pricing providing for appropriate generator profit during periods of shortage. Ex post monitoring should allow longer term replacement of BM offers as a sanction for non-compliance.

*Which ex-ante bidding/offer market power mitigation options for the DA and ID markets do you favour – bidding principles and ex-post assessment, or ex-post assessment only? Where feasible please relate the preferred approach to the five key principles for this workstream of effective, targeted, flexible, practical and transparent.*

We support bidding principles in the DAM and IDM that require generators not to deviate from reasonable cost recovery. The principle needs to take into account the cumulative position of both market over a reasonable period of time, e.g. no more than one or two days. The bidding principles should be at high level, noting the highly coupled nature of these markets to European neighbours which would not have the same bidding requirements.





The efficacy of this approach lies with the development of the metrics and the resourcing of the MMU. Such an approach would need to be accompanied with a high level plan from the SEM Committee as to the level of resourcing it was intended to put behind the decision. The less resource the SEM Committee can commit to, the more severe and less flexible the bidding principles must become.

*If ex-ante bidding principles were to be adopted, how flexible should they be and how would this be facilitated/enshrined in their wording?*

See comment above.

*Under what structural conditions or in combination with other market power mitigation measures should vertical ring-fencing of the incumbents be relaxed?*

It should not be. We note the design of the physical markets which has driven vertical ring-fencing of all participants when it comes to trading of power. We ask why the market power workstream in contrast appears to leaning towards commercial ring-fencing being removed, thus internalising the management of risk with larger, generation-long vertically integrated players.

*Under what circumstances and criteria (or metrics) should the application of ring-fencing to other market participants be considered?*

We believe vertical ring-fencing should be applied while:

- A deeply liquid and transparent forward market in which market power cannot be exercised and does not exist;
- The I-SEM HLD requires such ring-fencing in the physical markets, i.e. a generators in a VIU must go to the open market to trade, it cannot trade with itself; and
- There remains structural barriers to entry in development and connection of new generation capacity which would allow new entrant suppliers access to the VIU model.

