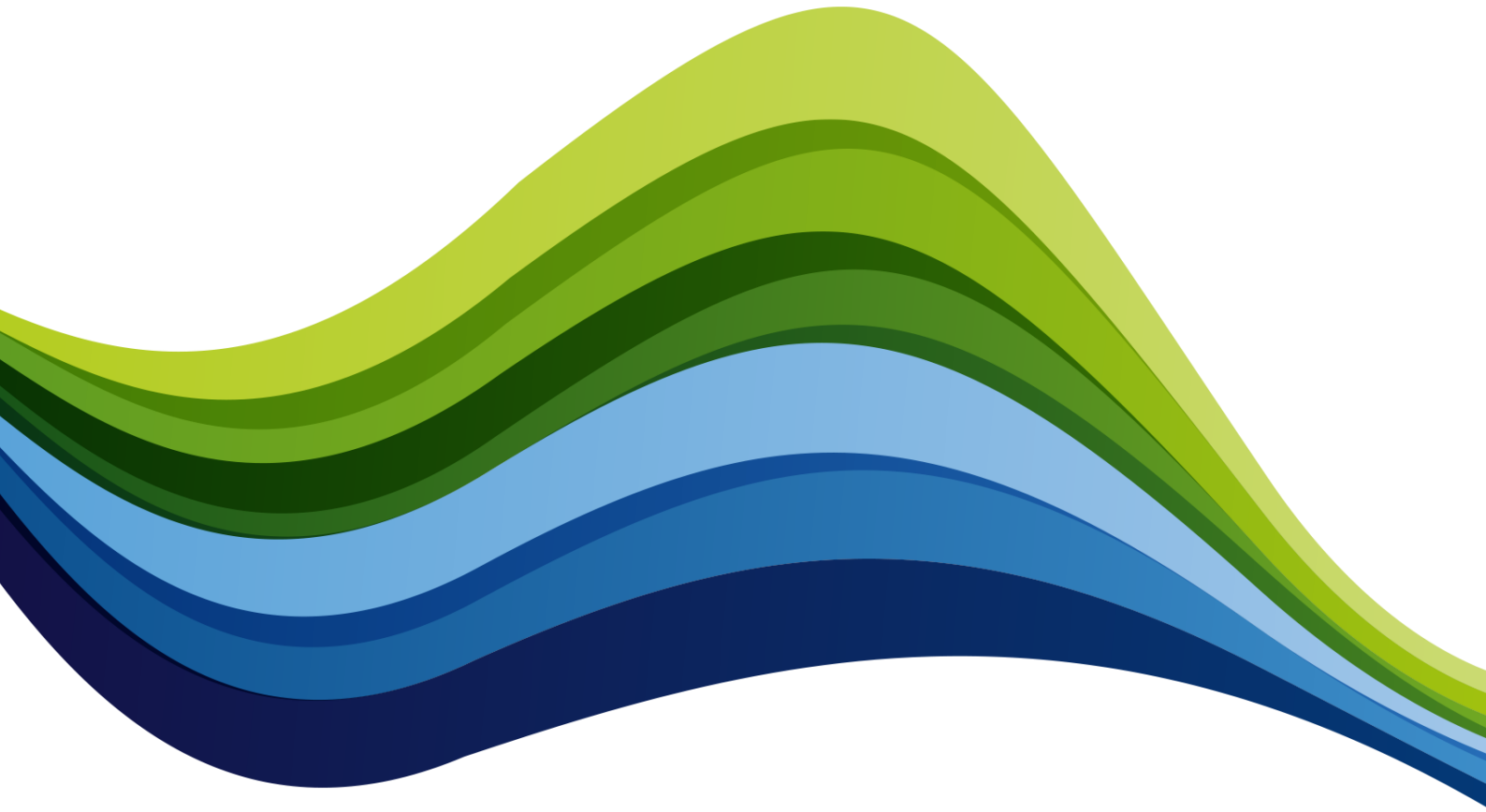
I-SEM

Market Power Mitigation Consultation Paper

(SEM-15-094)

If you have any questions in relation to our response, please don't hesitate to contact me at connor.powell@sse.com



Introduction

Thank you for giving SSE the opportunity to comment on I-SEM Market Power Mitigation. SSE is a utility with customers and assets in both Ireland and Great Britain – we have operated under a number of different electricity trading and transmission arrangements. To secure energy for its Irish customers, SSE is involved in energy portfolio management, electricity generation and gas production. We have tried to reflect this experience in our response.

Our priorities for I-SEM design are system resilience, competitive markets and a decarbonised future. Our assets keep the lights on by being available to produce energy when required and flexible enough to respond to changes in demand/wind when they occur. Our retail business supplies around 800,000 customers securing long-term supplies and managing a range of market and non-market risks on their behalf.

Market Power is a critical workstream given that choices around intervention could radically alter system resilience, energy affordability and the transition towards more sustainable forms of electricity generation. **We are concerned that the thinking outlined in the RAs consultation paper represents an extension of existing SEM solutions, rather than a new market power framework tailored to an entirely different market design**. Specifically, we are concerned that the mitigation options proposed would:

- Severely restrict commercial behaviour;
- Dampen commercial incentives to participate in I-SEM;
- Undermine liquidity and price discovery across all I-SEM physical markets;
- Distort price signals and discriminate against certain technology types.

We are not convinced that the RAs have properly thought through the structural problem this workstream needs to address, the issues that structural problem creates and solutions that coherently fit within the existing I-SEM decisions (SEM-15-063, SEM-15-064, SEM-15-065 and SEM-15-103). SSE believes that the package of measures within SEM-15-094 would actually exacerbate market power:

- Restricting cost recovery at some (but not all) generation assets;
- Preventing efficient price formation across all physical markets;
- Prescribing a one-size-fits-all commercial framework for new and existing entrants;

The RAs appear to be 'tackling' structural market power by introducing risks that are best managed by a dominant participant with a large, diverse existing portfolio. For any new entrant, their innovative business model or technology has to fit with the commercial restrictions imposed to 'control' ESB. Existing participants with smaller, less balanced portfolios have to hope that their generation assets can survive the distortions created across core physical electricity markets. **The large, diverse portfolio of the incumbent can manage these risks across a portfolio containing multiple technologies and retail and generation arms that can freely reallocate revenues/costs through forward contracts.**

We believe that a more realistic package of market power mitigation measures would recognise: the very different I-SEM market design outlined by the SEM Committee in decisions to date[1]; the key concerns of smaller market participants[2] and the radical changes to generation mix that have taken place[3] in the all-island market. SSE's solution would:

- Recognise the structural market power problem that exists in Ireland and acknowledge the limitations[4] to fundamental change over the next 10 years.
- Identify the key barriers to competitive markets – for new suppliers this is primarily access to liquid forward markets, for existing generators and new generators, this is primarily severe restrictions on innovative commercial arrangements and access to transmission capacity.
- Account for the 'market power mitigation' elements already present in existing I-SEM decisions (exclusive DA/ID markets and unit based bidding in SEM-14-085, reliability options hedging suppliers across all physical markets in SEM-15-103 and trading against the TSO functionality in SEM-15-064)
- Recognise the obligations placed on market participants by REMIT.
- Adapt/use the existing wide ranging suite of powers granted to both CER and NIAUR by the Regulation on Energy Market Integrity and Transparency.
- Design solutions that account for the remaining gaps – creating incentives to trade forward, removing or changing rules that prescribe a one-size fits all mix of revenues from capacity, ancillary and energy markets[5] and removing the 'tax' on entry/exit created by poorly designed connection policies that favour speculative rather than committed investors.

Given the I-SEM HLD and use of the tools already introduced through REMIT, there is no substantial risk of market power being exercised to substantive detriment of either customers or other market participants at I-SEM go-live. However, there is a substantial risk of layered solutions causing significant financial damage to smaller participants, discouraging new entrants and exacerbating the existing structural problem. Intervention comes with major downside and limited upside – any package of measures needs to be very carefully designed, and doesn't necessarily need to be fully in place for October 2017[6].

Our response to this consultation covers each of the areas in the consultation paper – we have proposed more detailed solutions at the beginning of the section on Market Power Mitigation.

[1] Organic price formation as opposed to mechanical cost reflection
[2] Primarily relating to forward liquidity and risk management, rather than price volatility
[3] These continue to take place
[4] Making clear the reason for these limitations
[5] Existing SEM rules effectively erect a barrier to any form of large scale storage technology outside of the ESB site at Turlough Hill
[6] Some mitigation measures can simply be tailored to the market information revealed after go-live

Relevant Geographic Market(s) and Trading Period(s)

Relevant Markets

We agree with the definitions of Forward, DA, ID and Balancing markets outlined in the consultation paper. We also agree with the application of a clear distinction between market power that applies across the bidding zone and local market power that applies to weakly connected areas of the transmission network within the bidding zone. Local market power must be considered separately to market power across the bidding zone, given that the former does not impact on market clearing prices and has already partially been addressed through decisions in SEM-15-064.

> ***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 proposed markets, trading periods and geographic scope identified in the paper. We think the RAs should explicitly separate bidding zone and local market power and deal with both separately.

I-SEM Design, Interactions and Implications

Defining, rather than facilitating competition

The key assumption underpinning the RAs consultation paper is:

"Competitive offers equal short run marginal cost (SRMC), where SRMC includes relevant opportunity costs. *It is important to note that SRMC-based pricing in the physical markets is compatible with the commercial objective of efficient generators to recover both fixed and variable costs through market revenues, through inframarginal rents accrued and/or through capacity payments."*

We would challenge this:

- This may be true in a purely theoretical view of an electricity market with no transaction costs, where investors simply add and subtract MW of capacity with no friction. In reality, substantial MW of entry is incentivised through out-of-market supports, new capacity has substantial lead-time and generators come in discrete blocks rather than fractions of MWs.
- If you take an example of an inframarginal generator, the power exchange solution underpinning I-SEM means that it has to internalise and simplify complex costs into simple order types. It must reflect a perfect view of its future running profile along with perfect foresight of availability, forced outages and maintenance costs, and the inframarginal rent it will lose to 'price-indifferent' generation. **It must then hope that every other competing generator has perfectly reflected its own complex costs and future operation in simple offers; otherwise its own calculations will be in vain**. This

is already fairly improbable, and we haven't even begun to explore the imperfect information a generator will have at the point at which it constructs a bid for the capacity auction.

- If you take an example of a marginal generator required for either specific system services or local transmission constraints, its revenue recovery is now dependent on regulatory goodwill, rather than commercial behaviour. Without expectations of inframarginal rent and no allocation of a capacity contract, it has to hope that administered scarcity pricing is triggered. The RAs seem to entirely ignore the opportunity cost associated with the risk that ASP might not be triggered in a future year – loss of load isn't a guarantee (or a desirable outcome).

There are lots of reasons that prices may deviate from SRMC across trading periods, most of which primarily relate to the imperfect information participants in markets will always have at the point at which they submit offers to buy or sell. Things like transmission constraints or dynamic requirements for system services magnify the impact of that imperfect information further. Defining anything that deviates from a defined price level as market power is not going to lead to competitive offers. **The RAs should be trying to facilitate competitive offers – not attempting to strictly define what is and isn't a competitive offer.**

Forward Markets

Given that the primary market power concerns of most market participants relate to forward liquidity, we are disappointed to see that the RAs have entirely dismissed analysis of the forward markets on the basis that:

1. *"Potential buyers of forward contracts "can choose not to contract at a price that is above their expectations of the spot price (i.e. remain unhedged) or use alternative forms of hedging, such as the purchase fuel of hedges".*

   Buyers can choose to remain unhedged, adding substantial financial risk to their future operations, or proxy hedge through fuels, adding substantial basis risk to their future operations. Neither are great choices. The common factor to both being that a lack of forward contracts adds substantial risk to the future operation of a supplier which any prudent supplier should factor in, making them less competitive against incumbent suppliers that have a natural portfolio hedge. NIAUR has already acknowledged that the lack of hedging opportunities in SEM adds considerable costs to a standalone regulated[7] supplier. **We cannot see how the RAs dismiss this – lack of forward contract availability is one of the main barriers to competitive retail markets in the all-island market and results in additional costs for customers.**

2. *"Arguably barriers to entry, i.e. the provision of forward products, should also be lower than in the physical markets given that large scale assets (generation plants) do not need to be built in response to price signals. These factors would tend to limit the potential for forward market power, as assetless traders could also offer CfDs."*

[7] This additional cost estimated by NIAUR for PowerNI only takes into account the additional working capital needed to operate in SEM – it does not need to fully account for cash flow volatility as the regulated supplier benefits from a k-factor cost recovery mechanism.

While assetless traders can offer CfDs, they are taking on pure price risk with no natural internal hedge. **Price risk is by definition, risky, particularly without a liquid underlying market in which you can freely enter and exit positions.** Offering standalone CfDs is therefore expensive as a result of high risk premiums, particularly given the cash flow volatility that results from a contract referenced against a market for a commodity that is by definition, volatile. **A cursory examination of the existing OTC market would demonstrate that a lack of liquidity creates a major barrier to participation for traders without an underlying physical position.**

3. *"Furthermore, ongoing EU regulatory developments such as EMIR and MiFiD assist in detecting and preventing market power abuse in the forward financial market, with a role for the relevant financial regulatory authorities in relation to this matter."*

   Delinking and then subsequently abdicating responsibility for a key element of the I-SEM market to financial regulators who have limited knowledge of, and interest in the underlying physical electricity markets is not sensible. EMIR is a regulation primarily designed to increase transparency of OTC derivatives. MiFiD II is a wide-ranging regulation that impacts directly on investment services and activities with commodities generally treated as an ancillary service for participants below a certain size. **Neither of these financial regulations replaces the duties that the RAs have to promote competition in the generation and supply of electricity and ensure that licenced entities do not engage in market abuse.**

SSE strongly disagrees with the dismissal of participant concerns with regard to forwards. We would recommend that either the mandate for the Forwards & Liquidity workstream is amended to explicitly address market concentration, or that the Market Power workstream actually carries out an assessment of volumes and trading activity across the existing DC and NDC offerings under SEM, keeping forwards within scope. **The RAs cannot allow forward markets to fall into a gap between two workstreams – they are central to competitive retail markets.**

Physical Markets

We have amended the table provided by the RAs on Page 31 to reflect our own analysis of the market power mitigation measures already incorporated into I-SEM design:

Design element	Market power implications
Unit-based bidding in DAM, IDM, BM	• Weakens the incentive to deviate from marginal cost (MC) bidding, because offers linked to individual generators/units are easier to compare to unit's MC than offers based on a portfolio of generators. • Makes market power monitoring/mitigation easier. • **Weakens incentives for portfolios to withhold bids/offers from physical markets, given that a portfolio is broken into its constituent demand and generation unit components for the purposes of imbalance settlement.**
Offer/bid	• Unlike in SEM, offers in I-SEM will no longer have a separate component for

format in DAM and IDM	(1) energy; (2) no-load, and (3) start-up costs required at all times. • Makes potential verification against SRMC more difficult, since in order to recover their fixed (start-up and no-load) costs, generators may have to increase their offers above MC. **Verification against SRMC assumes prescription of bidding at SRMC and both uplift and make-whole payments – both of which are not possible under EUPHEMIA/XBID. SEM concepts of MC bidding are obsolete in I-SEM. Market monitors across multiple different markets identify manipulative behaviour without narrow concepts of what allowed 'costs' should be – the I-SEM MMU simply needs to update its methodology.** • Hourly offers vs. single daily offers in SEM may potentially create more opportunities for market manipulation. **This is not a 'design choice', it is a requirement. Dynamic markets are by definition, dynamic, with more opportunities to incorporate new price information into the market. This is not a 'bad' thing.**
INC/DEC bids and offers in the BM with mandatory participation	• Incremental (INC) offer: offer to increase generation or decrease demand relative to cumulative day-ahead and IDM trades. • Decremental (DEC) bid: bid to decrease generation or increase demand relative to cumulative day-ahead and IDM trades. • INC offers and DEC bids can be used as means of exercising local market power. **INC and DEC bids are simply the format through which generators reflect their desire to either maintain or move from their contracted position. While they can be used as a means of exercising market power, there are protections built into the I-SEM algebra (Trading against the TSO) and existing TSO practice (Operational Constraints Report).**
Physical notifications (PNs)	• First submitted to the TSOs by market participants after DAM close; will be the starting position used for imbalance settlement. **PNs provide more information on real-time plant positioning and expectations of future plant positioning than is available under the existing SEM for market participants.** • PNs must be linked to ex-ante positions at gate closure. Before gate-closure, PNs can represent the best estimate of demand or generation. • Exact requirement may have an impact on incentives and monitoring. **The I-SEM decision incorporated an information incentive set initially at zero – if market participants do not submit accurate information, this can be increased to provide an incentive to do so.**
Voluntary participation in IDM and DAM	• Identifying physical withholding may be difficult. **We do not agree – physical withholding is still easy to assess in I-SEM. Is a plant that is technically unavailable, actually technically unavailable? Has plant commercial offers suddenly moved from baseload to mid-merit/peaking? The RAs/TSO still have the information and expertise needed to answer these questions.** • Participation will be incentivised, given the fact that physical schedules are established in these markets **Yes – there is a very strong incentive for participants to contract in either DA/ID, unless they are flexible enough to respond within the Balancing Market.** • Participation may be mandatory for CRM RO holders

Individual market participant balance responsibility	• Submitted to the TSOs by market participants after DAM close; will be the starting position used for imbalance settlement. Final imbalance settlement will be based on trading positions in DAM, IDM, and BM. **As mentioned previously, balance responsibility along with unit based generation accounts provides a very strong incentive to offer capacity prior to the Balancing Market.** • Promotes convergence between intertemporal markets • May lead to greater liquidity in DAM
Reliability Options	• **All suppliers will be hedged from a strike price established through a regulatory methodology.** • **The RAs desire to provide strong exit signals through the CRM by applying an 8 hour LOLE will (if successful) dramatically tighten capacity margins and exacerbate structural market power in generation.** • **A Market Reference Price split across all market timeframes favours large flexible generation portfolios, like that of the incumbent.**

In total, the physical markets outlined in SEM-15-063, SEM-15-064 and SEM-15-065 contain strong market power mitigation measures which incentivise participation. The CRM approach chosen by the RAs in SEM-15-103 will exacerbate market power by tightening the overall derated capacity margin and through adding risks that are best managed through large flexible generation portfolios.

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

We do not. The RAs are defining rather than facilitating competition. Any calculation of competitive outcomes will inevitably be incorrect, which will directly harm smaller participants and new entrants rather than large incumbents.

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

The RAs undervalue the existing market power mitigation measures built into the I-SEM HLD and powers attributed to Regulators and obligations on Market Participants implemented through REMIT.

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?

No. The RAs assumptions are flawed. A simple analysis of volumes through the existing SEM OTC platform (while limited in some respects) would reveal that physical volumes are required to back financial contracts in an illiquid market. Existing NIAUR analysis demonstrates part of the additional cost faced by standalone suppliers unable to hedge Irish power exposure.

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?

Design elements of the CRM chosen and RA desire to force plant exit will inevitably exacerbate structural market power.

Relevant I-SEM Metrics

Market Power Metrics

While we broadly agree with the RAs selection of Market Shares, RSI, HHI and Generation Price Setting we are disappointed that the regulators have dismissed any real assessment of forward liquidity. A key requirement for retail competition is the availability of risk management products. The consultation paper states that liquidity measures are:

"Not a useful measure to draw conclusions about market power; liquid markets may not be competitive, and vice versa, illiquid markets may produce competitive outcomes."

These statements should be referenced – generally, high churn rates, tight bid offer spreads and the other hallmarks of liquid markets reflect participant confidence that both prices and volumes within a market are competitive. **Participants are confident that they can enter positions at fair prices, and that sufficient volumes will be available in future so that they can exit positions at fair prices.** SSE believes that market liquidity generally represents participant confidence that no one participant can set prices, or dictate overall volumes.

The RAs intend to audit generator outages and derates in order to establish whether the I-SEM is sufficiently liquid. This simply establishes whether capacity is being withheld from physical markets, which is a separate consideration to whether those markets are sufficiently liquid. The MMU should be looking at Forward, DA and ID volumes and spreads to assess whether participants are confident that market power over price and volume is limited.

> ***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?***
>
> The liquidity assessment chosen is not an assessment of liquidity. Forwards should be within scope and the RAs should assess both bid/offer spread and volumes across I-SEM.

Estimate of I-SEM Market Power

Market Shares and Market Power

The RAs estimates of future market shares are fair – they are a product of assumptions[8] but those assumptions reflect the information known to the TSO and the RAs at present. However, given that an objective of the I-SEM CRM is to sharpen exit signals, a further

[8] Most importantly, that plant exit signalled through the GCS, which is generally a result of the IED is accurate. Once LCPBREF is finalised, these assumptions can be updated. Wind build out is another key assumption, although projecting forward company wind ownership shares in 2014 will be highly inaccurate – development pipelines and acquisition appetite will dictate future capacity – neither match existing ownership.

analysis of generation capacity shares removing plant with low dispatch market share or net profitability as provided through Generator Profitability in the SEM reporting would be useful[9].

The analysis carried out by the RAs reveals that:

- HHI demonstrates market power up to 2024 in peak hours.
- This is particularly important for the capacity auction which by definition is a one-time auction during a stress period.
- RSI demonstrates a broadening of price setting plant as a direct result of the build-out of price indifferent wind generation.
- This shows that market power is less of a concern in physical markets under most normal[10]conditions.

Capacity auctions are vulnerable to the exercise of market power by a structurally dominant player. Sustained periods of low wind generation are vulnerable to the exercise of market power by a range of players. The first is difficult to mitigate, outside of measures relating to participant conduct. The second is simple to mitigate through market structure – particularly if suppliers have risk mitigation products available to them through liquid forward, DA and ID markets.

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

While we broadly agree with the modelling approach taken, we believe that a further scenario should be plotted in which 'exit' is encouraged by marginal generators.

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

No – the conclusion drawn appears to be that the capacity market is not important, while the balancing market (which represents a small exposure for most participants) is important. It also appears to suggest that mitigation is ex-ante control of conduct. SSE believes that the opposite is true – conduct in the CRM is important, while market power in Balancing can be managed through design choices that are already built into I-SEM.

Review of Current SEM Measures

MMU and BCOP

SRMC bidding is a SEM concept, which functions well in a market with more 'information' known ahead of real-time – for most participants, recovery of fixed costs can be assumed through the CRM and risk relating to assumptions around future market schedules is reduced. The CRM design converts market risk into regulatory risk, meaning that for most

[9] We do not expect accurate estimates of fixed costs, so dispatch market share or generator profitability is a very approximate estimate of 'value' to the system and 'value realised'.
[10] Broadly expected wind, demand and availability conditions

participants, they can more accurately calculate and convert SRMC into complex commercial offers. This is not true under I-SEM.

SRMC bidding is obsolete under the I-SEM HLD, which does not attempt to convert market risk into regulatory risk. **Multiple competitive auctions with imperfection information about future market share, costs and revenues require dynamic, competitive behaviour as a response.** Restricting dynamic, competitive behaviour might work for SEM, given its unique design – it will not work in I-SEM.

Directed Contracts

While DCs reduce incentives to manipulate the spot market, this is already clearly addressed by the MMU and BCOP. What DCs do is provide a limited volume of forward contracts in the absence of generator incentives to contract forward[11]. We are disappointed to see that the RAs have not assessed the OTC market, and the evidence they have on commercial terms is anecdotal, rather than concrete. Risk management products have not been available to suppliers in sufficient volume to provide a level playing field for retail competition – this is not necessarily a result of DCs, but DCs have not been successful in resolving the underlying issue.

Vertical Ring-Fencing

Vertical ring-fencing has one key result: it forces both Viridian and ESB to contract through public markets, rather than internally. This isn't necessarily relevant to Viridian who do not have significant market schedule or dispatch in generation, but is relevant to ESB, who have significant market schedule and dispatch in both retail and wholesale markets.

If vertical ring-fencing was removed for ESB, risk could be managed through Group Accounting and internal transfer pricing, rather than through transparent markets. This would be a disaster for any public forward markets and in particular for net short participants. We are disappointed to see that the RAs analysis of vertical ring-fencing does not include any detailed assessment of the operation of NDCs beyond a statement that:

"For example, the RAs have no evidence that ESB is offering NDCs to Electric Ireland cheaper than rival suppliers."

Ring-fencing is not just meant to prevent group transfers from generation to supply. It should prevent transfers marked at a 'group' price rather than at a market price.

> ***Do you agree with the SEM Committee's view on the effectiveness of each of the SEM market power mitigation measures?***
>
> No – the actual result of directed contracts is missed as is any analysis of ring-fencing.
>
> ***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?***

[11] As noted in the section above, SEM converts market risk into regulatory risk – most generators do not have to contract forward to derisk their budgets.

The MMU is still relevant, even if its methodology needs to be updated. Strict SRMC bidding is an obsolete concept. If Directed Contracts are to be retained, they need to have a clear aim – at present, they do not address the concerns of market participants. In the absence of divestment, ring-fencing of ESB is a clear requirement in I-SEM.

I-SEM Mitigation Strategy and Measures

SSE disagrees with the analysis and measures proposed by the RAs. While the paper defines principles for measures, it also assumes that SRMC bidding as the competitive conduct and performance. This immediately means that the measures selected cannot be **targeted, flexible, practical** or **transparent.** Our solution first assesses the barriers to competitive outcomes:

- Structural dominance in generation capacity share, schedule and retail demand.
- Major transmission constraints within the bidding zone.
- Limited risk mitigation products available to new or expanding suppliers.
- Severe restrictions on commercial behaviour imposed on new generators.
- Lack of access of transmission capacity across Ireland.

Assessing existing legislation and the I-SEM design for mitigation measures, we can see that exclusive DA/ID markets partially mitigate structural dominance. BM design (algebra and flagging/tagging) and market monitoring mitigate the impact of transmission constraints. Reliability Options somewhat mitigate the risk of high price periods across a year for suppliers. REMIT provides comprehensive data and a suite of powers including enforcement through financial penalties that allow the RAs to intervene in instances where market power is exercised.

The elements unaddressed are:

- Structural dominance in the capacity auction.
- Limited risk mitigation products available to new or expanding suppliers.
- Lack of transmission access.

Addressing structural dominance in the capacity auction is difficult: as the RAs analysis shows, ESB's share of dispatchable price making capacity in the auction will increase year on year. The capacity auction will be the key lever through which a dominant generator can manage entry/exit of competitors**. We believe that the RAs should explore the potential of applying a hard price floor and price cap**[12] in the auction mechanism, to ensure that dominant players cannot extract supernormal profits, or force closure of competing generation assets.

Market Power in Forwards shouldn't fall between workstreams: the RAs must either explicitly address it as part of the Market Power workstream, or explicitly address it within the Forwards and Liquidity workstream. Lack of hedging opportunities imposes a clear cost

[12] A price floor for dominant participants would have to be adjusted for technology – fixed costs vary depending on generation asset.

on competing suppliers that has already been acknowledged (and partially calculated by) NIAUR. A redesigned forwarding contracting obligation could help to address this.

Transmission access remains a problem: poorly designed connection policies favour speculative rather than committed investors. This imposes a tax on any new entry, favouring generators and developers with existing connection offers. There is also no attempt to manage increases in structural market power through transmission access – ESB can apply for/hold transmission access without any consideration of market concentration. While CER appear to be addressing some of these issues, NIAUR have changed their connection policy to favour speculative application.

Addressing these three items should form the basis of any market power strategy. We will contrast these measures with the approach outlined by the RAs in SEM-15-094. **The RAs attempt to avoid what they define as Type 2 errors, ensuring a surplus of Type 1 errors.** While a dominant incumbent with a large, naturally hedged portfolio can survive over-mitigation (for a period); over-mitigation explicitly punishes smaller participants who are dependent on cost recovery through a limited number of assets or customers.

Forward Contracting Obligation

We would agree that a more flexible approach to any FCO is required. We do not believe that a reapplication of the SEM approach will deliver in I-SEM. Instead, SSE would recommend that:

- The RAs focus on standardising products – those offered through a FCO should be fungible – equivalent to forward contracts traded without regulatory direction.
- Setting the volume requirement on the basis of reducing HHI in the spot market is not the correct approach (even within SEM, where spot market is controlled through BCOP). The RAs should focus market liquidity – ease & equity of participation. This should mean setting output % volumes offered in a mandatory auction through a standard methodology for participants deemed to have market power.
- Not prescribing price – setting a regulated price ensures that the participants on which the obligation is placed will not be happy with the result (the regulated price will be wrong) and the participants allocated the volumes will be unhappy (they will always want a different allocation of volumes). Setting a floor price and allowing participants to determine price and allocation is an approach more in line with I-SEM.

An FCO could take the form of mandatory auctions– the key to both is incentivising the incumbent to participate by making markets for forward power, rather than forcing reallocation of power at regulated prices.

Balancing Markets

The Balancing Market shapes prices right across the curve – expectations of balancing market dictate participation and behaviour in ID, DA and forward markets. Any prescriptive intervention in balancing cannot meet the SEM Committee's own criteria – **targeted or flexible.** It will impact price across every market, creating a huge number of Type 1 errors:

- Restricting cost recovery at some (but not all) generation assets

- Preventing efficient price formation across all physical markets
- Prescribing a one-size-fits-all commercial framework for new and existing entrants

The paper suggests that prescriptive intervention is warranted on the basis that:

"There may not be a sufficiently competitive dynamic in the BM to drive offers to the level of SRMC. In addition the constrained nature of the all-island power system means that any generator may possess local market power in the BM for non-energy actions at some point."

This is the definition of untargeted – applying regulated prices in some form to all generators in balancing because they 'may' at some point have market power. The regulated prices in turn feed through into clearing prices across the curve**. SSE rejects Option 1, 2 and 3, which all act to restrict competition and strongly favour the incumbent generator.**

If the RAs wish to intervene in balancing, a lighter touch regime is required – the RAs need to provide clear guidance on what is considered acceptable market practice, and allow participants to compete within that loose framework. Article 2(2)(a) of REMIT explicitly states that market manipulation is:

(a) entering into any transaction or issuing any order to trade in wholesale energy products which:

> *(i) gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of wholesale energy products;*
> ***(ii) secures or attempts to secure, by a person, or persons acting in collaboration, the price of one or several wholesale energy products at an artificial level,*** *unless the person who entered into the transaction or issued the order to trade establishes that his reasons for doing so are legitimate and that that transaction or order to trade conforms to* ***accepted market practices on the wholesale energy market concerned;*** *or*
> *(iii) employs or attempts to employ a fictitious device or any other form of deception or contrivance which gives, or is likely to give, false or misleading signals regarding the supply of, demand for, or price of wholesale energy products.*

This is a comprehensive definition of market manipulation **– the only remaining element for the SEM Committee is to define accepted market practices under I-SEM – an Option 4 for balancing that appears to be left out of the consultation paper.** Options 1, 2 and 3 ignore this, and simply define 'accepted market practice' as a regulated SRMC cost curve, with any deviations from this as market manipulation.

DA and ID Markets

The options provided by the RAs for DA and ID markets are similarly prescriptive – they simply define accepted market practice as SRMC orders and classify anything outside that narrow definition as market abuse that requires either enforcement or ex-ante control. None of the existing I-SEM design measures referenced in Section 5 are considered to have any effect despite their earlier appearance in the consultation paper, hence the requirement to define a regulatory price as a competitive outcome.

Options 1 to 3 again all favour the incumbent generator, whose business model already fits within the prescriptive, established commercial framework established by SRMC bidding controls. Each will act to exacerbate structural market power and prevent entry or expansion by competitors.

Option 4 is less prescriptive – it does not attempt to introduce regulated pricing into the I-SEM wholesale market, but the principles outlined have already been introduced through REMIT obligations. **SSE would therefore favour implementation of Option 4 through transparent definitions of acceptable market practice (focusing on behaviour rather than price) rather than an additional licence condition.** This allows generators to compete, with additional information provided by participants with structural market power. The RAs are able to step in if they believe markets are not resulting in competitive outcomes.

Vertical Integration

As stated above, vertical ring-fencing has one key result: it forces both Viridian and ESB to contract through public markets, rather than internally. This isn't necessarily relevant to Viridian who do not have significant market schedule or dispatch in generation, but is relevant to ESB, who have significant market schedule and dispatch in both retail and wholesale markets.

If vertical ring-fencing was removed for ESB, their market risk could be managed through Group Accounting and internal transfer pricing, rather than through transparent public markets. This would be a disaster for any net short participants. SSE would therefore favour the maintenance of vertical ring-fencing licence conditions for ESB.

> ***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.***
>
> SSE agrees with the principles, but it does not seem the RAs have applied them in analysis of proposed market power mitigation measures. For example, none of the measures proposed for balancing is targeted – it impacts all generation and all supply by distorting prices across the curve.
>
> ***For the Forward Contracting Obligation:***
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> ***- 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?***
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> The FCO is designed to facilitate retail competition; therefore the RAs should target an overall liquidity target, rather than tweaking HHI numbers to an acceptable level.
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> ***- What should be the volume and product definition of forward contracting required from a market participant who falls under the FCO?***
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> Requirements should be set at a manageable % of forecast generation schedule or dispatch volume. Products should be standardised and fungible.
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> ***- How should the price be set for the volume contracted under the FCO?***
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> Prices should be competitive, set through auction.
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> ***- What type of access should buyers have to FCO volumes?***

Access should be allocated through auction – this means all suppliers have equal access to forward volumes, if they value them.

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?

Each of these options strengthens, rather than reduces structural market power by discriminating against smaller portfolios. REMIT provides sufficient powers to oversee the I-SEM balancing market, if the RAs define acceptable market practice.

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?

The Market Abuse Licence Condition is unnecessary as it is already covered through REMIT obligations. Other options strengthen rather than reduce structural market power.

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

Ex-ante bidding principles should define accepted market practice, not acceptable market prices.

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

Vertical ring-fencing should only be relaxed if forward liquidity measures rise above a defined level, and both wholesale and retail market shares in dispatch and scheduling drop below an acceptable level.

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

If both generation and retail market shares rise above an acceptable level.