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SEM Consultation Paper SEM-15-094
I-SEM Market Power Mitigation

Vayu welcomes the opportunity to comment on the SEM Committee's ("SEMC") consultation paper – SEM-15-094. The decisions from this consultation will have long term impacts of the developments for all sectors of the electricity market - wholesale and retail. It will crystallize investment decisions for new entrants and may even accelerate exit of capacity in the market.

We noted from the discussions to date that there was an oversight in the paper by the omission of a principles-based option for bid mitigation in the Balancing Market ("BM"). It is imperative that the Regulator Authorities ("RAs") clarify this position and that we will see this in any draft or final decision.

We are open to discussing our views in more detail and our comments on specific questions follow:

Section 2 – Market Power Policy Development

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

Yes for the most part, particularly so with increased interaction between neighbouring markets and the fundamental change from a 'mechanistic' bidding environment in the SEM pool to bilateral trading and the BM.

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

There are a number of additional factors that we would consider relevant. We believe that a successfully functioning spot market is a necessary but not sufficient condition for a forward market to develop. Therefore some effort should be devoted to ensuring that a reasonably liquid, transparent forward trading market is available in advance of the I-SEM start date to enable participants to effectively manage their risks.

We would ideally have liked to have seen views on the wider policy context across the EU and the relatively swift changes occurring in the energy mix e.g. the prevalence of coal in the system, the transition of the electricity system as detailed in the EUs new market design consultation, longer term impacts from the decisions taken at COP21, etc.

Decarbonisation of the electricity system is not solely about the development of renewable generation. Market power should not be allowed to stifle competition from demand management and reduction, energy storage and new interconnection. The market should also be able to accommodate future load growth from low-carbon electric heating and transport.

Barriers to entry to the market should also be considered. In particular the cost of compliance, IT system costs and credit/collateral costs should not deter new entrants and innovation.

It should not be assumed that banks and financial participants will provide for market liquidity, even with forward trading conducted on a financial basis. These participants have contracted considerably in the scale and scope of their risk taking since the financial crash. They are unlikely to be attracted to a relatively small market where there is insufficient liquidity and/or mechanisms to effectively manage and close out risks.

An effective market requires a diverse range of willing buyers and sellers to function. The regulatory authorities should generally follow principles that aim to deliver this by addressing market concentration, vertical integration and barriers to entry that would act in opposition to this goal.

We would have liked to have seen views on the wider policy context across the EU and the relatively swift changes occurring in the energy mix e.g. the prevalence of coal in the system.

Section 3 – Relevant Geographic Market(s) and Trading Period(s)

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

In general we agree with the proposed markets and trading periods for assessing market power. We also consider it important to take account of time of delivery as well as time of trading. Examples of this would be generators' power to raise prices either at peak times or constraints, as well as demand-side power being used to depress prices overnight on a regular basis.

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

Again, in general we agree with the proposed geographic scope of the proposed market/trading periods. However, we would also suggest considering the time dimension for constraints. Taking advantage of a short-term constraint for maintenance to raise prices might well be deemed to be market abuse. Gaining profit from increased prices over a longer period from a continual constraint could signal a situation where grid reinforcement is required or an opportunity for investment in other system services e.g. demand reduction.

Section 4 – I-SEM design, Interactions and Implications

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

Yes, we agree with the proposed definition at a high level that deviations from SRMC constitute a possible deviation from a competitive outcome. However, we would re-state our previous point that market signals may be necessary to encourage investment (e.g. in transmission improvements to alleviate constraints) or innovation.

In addition, anti-competitive behaviour may also be exercised by participants that can threaten to use market power even while operating at SRMC on an ongoing basis. For example, a generator with substantial mothballed capacity could threaten to restore this capacity to operation to deter new entrants.

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

The suggested examples capture many of the situations in which market power can be exercised. We would suggest that some more consideration should be made of the potential for market power on the demand side.

We do not consider it sufficient to expect that asset-less traders will offer CfDs and deliver market liquidity. In order to be confident of managing risks in the market, participants will require access to physical assets or a market that is already liquid.

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?

We do not agree that the potential for market power abuse in I-SEM is weaker in the FFM compared to the physical market. There is potential scope for larger and, in particular, vertically integrated participants to withhold volumes from the forward market or prohibitively pricing products, denying access to risk management products for their competitors, if controls are not put in place.

Other market participants should not be expected to take on the risk that physical markets will turn out 'better' or at their price expectation and, as previously noted, we do not consider it sufficient to expect that asset-less traders will deliver liquidity.

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 agree with these implications with a few qualifications. On the physical market, we would encourage examination of the demand side as well as generation market power. With the CRM, we share concerns that generators may bid below the strike price on their ROs and exercise market power. We agree that, in general, owners of FTRs alone will have limited ability to manipulate market prices, but there exists the possibility that participants with other market power could purchase FTR's to gain further or less obvious benefits from their market power. For example, a generator intending to raise peak I-SEM prices or increase price volatility could purchase FTR’s in advance of engaging in this practice. The generator would benefit from the increased value captured by the FTR’s as spreads between the I-SEM and the external market widened.

On DS3, we agree that careful monitoring of both markets and their interactions will be required. We believe that principle-based regulation may assist in this area, with participants adhering to the principle that they will not take advantage of a position in one market to unfairly influence the other.

Section 5 – Relevant I-SEM Metrics

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

Generally yes, these are a reasonable set of metrics to examine the physical wholesale and generation sectors of the market. Depending on how the I-SEM design develops the RAs may need to consider demand side in future. It is also important to consider contractual positions and the forwards market. If opportunities exist to wield market power in these markets there could be a consequential (or intentional) impact on the balancing mechanism and by implication pricing.

Are there other metrics that you consider should be applied?

Tracking volatility in prices and correlation with gas price movements might assist in identifying potential exercise of market power. Tracking the premium or discount of forward contract prices relative to the spot prices might also highlight patterns of possible exercise of market power (although changes in this differential will typically be a result of normal market activity.)

Section 6 – Estimate of I-SEM Market Power

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

We agree that the RAs have made a useful attempt at quantitative analysis to demonstrate the potential for continued generator market power in the I-SEM. We would like to see this analysis extended to cover the potential for vertically integrated companies to exercise market power and the demand side too. It may also be useful to use France as the source of additional interconnection rather than GB, given that Eirgrid has already commenced this process.

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

We agree that the analysis shows that ESB have and will continue to have a dominant position in the generation market. The main conclusion seems to be that a robust market power mitigation strategy will be required and we would welcome some further definition and clarity on what this will involve.

Section 7 – Review of Current SEM Measures

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

We agree that the MMU, Bidding Code of Practice and the vertical ring-fencing have been effective in making SEM a fairer and more competitive marketplace than would otherwise have been the case. While Directed Contracts may have helped reduce the incentives on ESB and PPB to exercise market power, they have not been a useful measure to assist other participants in managing risk on a cost-effective basis and so have not led to any increase in competition with any consequential natural erosion of their structural position.

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?

I-SEM will be a very different form of market from SEM and the application of market power mitigation strategies will need to be applied differently as a result. We believe that a purely mechanistic BCoP will be inadequate to cover all circumstances arising in I-SEM and that, as a result, the MMU will need to be more proactive and investigative in its work.

We would prefer to see any equivalent to the Directed Contracts and/or the Forward Contracting Obligation constructed in a way that better reflects the requirements of purchasers (e.g. pricing by auction, volumes and duration of contracts that better match supplier's sales in the retail market).

We would like to see the retention of some form of vertical ring-fencing or obligation for vertically integrated companies to trade volumes in the open market between their generation and supply divisions. This should be extended to cover any business that gains a significant (say greater than c.15%) vertically integrated market share.

Section 8 – Estimate of I-SEM Market Power

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 agree with the five key principles for assessing market power mitigation policies. We agree that such policies need to be 'Effective' but would seek to extend this to ensure that participants who have suffered from exercise of market power are compensated in addition to any penalties enforced against those that exercise market power.

We view the 'Targeted' principle as important to ensure that there are no unnecessary regulatory or administrative burdens on those participants that do not have market power. We agree with the principle that these policies should be 'Flexible', however this should not mean arbitrary and there is a need to balance the flexibility with stability for potential investors and market entrants.

The principles that market power mitigation policies should be 'Practical' and 'Transparent' are difficult to object to.

In addition to the principles noted, we would like to see that, whatever measures are used, they can be implemented in a timely fashion. There is little point in having these measures if they cannot be acted upon in good time.

Finally, we recognise and understand the potential for conflicts to arise between these principles but view at as the RA's role to strike the appropriate balance between them.

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?***

We take the view that this should be a clear and objective measure applicable to all market participants. Based on a HHI of 1,000, we would look for a vertically-integrated market share measure of c.15% on a participant forming a threshold for them to be included in the FCO.

- ***What should be the volume and product definition of forward contracting required from a market participant who falls under the FCO?***

We would look for any volume above the market share threshold to fall in to the FCO for the relevant market participants. We would expect the product definition to match potential purchaser's requirements for managing their retail business, i.e. a mix of annual, quarterly and monthly products to support hedging of customer sales contracts.

- ***How should the price be set for the volume contracted under the FCO?***

We would prefer the price to be set for these volumes through an auction or similar process to promote price transparency, rather than by an administered mechanism.

- ***What type of access should buyers have to FCO volumes?***

We would support the principle that buyers should have fair and equal access to FCO volumes. This would preclude FCO volumes from having unreasonable credit or other terms attached to them. We would accept that there might be some limit on the volume of FCO purchases that any participant could make to prevent any 'hoarding' of contracts.

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.

We take the view that all the market power mitigation measures may have a role, depending on how the market is implemented and subsequently develops.

We would see the MMU-triggered intervention option as being compatible with a flexible system of principle based regulation. This option would be made effective where the RAs, on MMU advice, have the appropriate powers to sanction participants that exercise market power and have an obligation to compensate the participants that have suffered as a result. By its nature, this MMU-triggered intervention would be targeted at the participants engaged in exercising market power.

Provided the MMU has sufficient resources to analyse the market and participants' behaviour, we believe it would be practical. MMU-triggered intervention might be slightly less transparent than some of the other measures suggested, but we believe this can be overcome through regular communications from the MMU and using previous decisions and interventions as precedents.

Retail suppliers in the I-SEM will have limited ability to exercise market power. Unless we see that the MMU has the ability to act swiftly and effectively to prevent market power, we believe that, as a retail supplier without generation capacity, we would lean towards prescriptive bidding controls as a preferred option in the balancing market. We believe it would create less volatility in pricing and would avoid having to go through investigations of market activity that could take much longer than anticipated.

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 would support the combination of bidding principles and ex-post assessment as a preferred market power mitigation measure, but would tend to support a focus more on the ex-post assessment as being more compatible with a principle based system of regulation. Some bidding rules may be effective and desirable, e.g. volume limits to prevent participants purchasing an excessive level of contracts in these markets, but it is unlikely that any set of bidding rules can be comprehensive in a bilateral market.

As detailed in the previous answer, we believe this option is inherently flexible and can be made effective and targeted where there is an appropriate system of sanctions on those that exercise market power and compensation for those affected. Practicality would arise from providing sufficient resource to the MMU and transparency would be addressed by setting out clearly the principles the MMU is operating to, communicating any issues of concern and using the precedent of previous interventions or decisions.

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 in themselves should be clear and relatively inflexible to provide clear signals for market participants to follow. However, these principles should provide for sufficient flexibility to deal with most situations where exercise of market power is occurring or has the potential to occur.

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

We believe that vertical ring-fencing should be relaxed only when a participant's market share has fallen below any specified threshold for the imposition of the ring-fencing, i.e. when structural conditions would support development of a competitive market themselves.

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

We believe that application of ring-fencing to market participants should be carried out in a similar manner to inclusion in the FCO. When a participant has an overall market share above the threshold (e.g. c.15% of both generation and supply) they would be expected to operate on a ring-fenced basis.