SEM Market Power and Liquidity

Synergen's response to SEM-10-084

1 Introduction

This paper is Synergen's response to the consultation paper SEM Market Power and Liquidity published by the RAs in December 2010 (SEM-10-084) and the accompanying CEPA report (SEM-10-084a).

The first section of Synergen's response contains our comments on those elements of the CEPA report where Synergen has specific views on the issues discussed. The second section of our response sets out our comments on the discussions at the 18th January workshop,. The paper concludes with Synergen's responses to the RAs' questions in Section 3 of SEM-10-084.

Synergen believes that it is inappropriate for it to comment on whether Synergen should, or should not, be integrated with other ESB-owned businesses. We have commented on CEPA Option A, however, as this does not reflect the present arrangements although the paper implies that it does. Synergen's comments in the remainder of this paper are not intended to indicate any preference for Option A, B or C, but as comments on some the market power mitigation measures that may be appropriate under each of those options.

2 General Comments on CEPA Paper

2.1 Comments on objectives and criteria (Section 2)

Synergen notes the objectives and criteria of this consultation and recognises that they are a fair reflection of the existing RA policy as set out in the papers referenced. The emphasis is very much on the prevention of the *abuse* of market power – not on reducing market power per se - and Synergen believes that this is critical. In the ongoing development of regulatory policy on market power, the emphasis must continue to be on ex-ante measures to prevent any abuse of and/or any benefit from market power. As the market matures Synergen believes that some restrictive measures should be revisited and relaxed, particularly in our own case where they are pre-SEM legacy restrictions which are no longer required.

2.2 Assessing Market Power (Section 3)

In Section 3.2, CEPA discusses the need to profitably sustain prices above a competitive level as a determinant of market power and predatory pricing, and economic withholding as tools that may be deployed in achieving market power. Synergen does not have the ability to exercise market power and has always contended that it should not be subject to the extreme ring-fencing currently imposed on the business to mitigate market power which it does not have and therefore cannot abuse. This remains our view.

The CEPA points set out in Section 3.4 are well understood by market players both in the context of the SEM, and other markets. Consequently, what is important is their specific application – and in this context we feel that the CEPA policy options set out in section 6 do not adequately draw out these product, geographic, and temporal market definitions.

Synergen accepts the CEPA assessment of market power and prices (Sections 3.6 – 3.7). In this context we note the assessment in section 3.7.3 that concludes that electricity price falls in the SEM seem to correspond with input fuel price falls. The

CEPA observation is that this is not a cause for concern, there is no prima facie evidence of predatory pricing. The observation that "falling profitability should not be taken to mean that there is no potential to exercise market power" is probably true, but it would also be true to observe that "even though the potential to exercise market power existed, there is no evidence that there was such an exercise of market power".

The CEPA paper seems to be saying that there would be potential to exercise market power if the current mitigation measures were removed. This is far short of presenting evidence of any attempts to abuse market power or any evidence that such abuse is even likely to occur should such mitigating measures be removed or any historically based evidence that such abuse has occurred. The lack of any abuse of market power to date should provide some confidence that:

(a) at a minimum the existing provisions have proved adequate and do not need to be strengthened; and

(b) some of the existing mitigation measures could be relaxed – notably Synergen's legacy ring fencing arrangements.

2.3 RSI analysis (3.8) and Conclusion (3.9)

Synergen does not have specific observations regarding the HHI and RSI calculations, nor the scenarios presented – recognising that they present a range of plausible market scenarios, which are sufficient for illustrative purposes.

The analysis presented indicates the susceptibility of any measure, whether HHI or RSI, to the threshold values adopted, and while there are precedents for alternative RSI thresholds, the value adopted would be a matter of regulatory discretion. This would strongly influence both the broader perception of market power and the need for mitigation measures, and the specific levels of DCs.

Synergen agrees with CEPA that the influence of interconnector flows on market power metrics is a critical issue and one where there is considerable uncertainty.

There is a theoretical incentive to withhold in the scenario where there is a flow from the SEM but Synergen believes that such a strategy is highly unlikely in practice. Although the withdrawal of plant by a large portfolio player could increase SMP and increase that player's overall returns SEM generators are not free to withhold capacity as they are bound by the Grid Code to declare plant available. A portfolio generator could seek to bend the availability rules but Synergen takes its obligations under the Grid Code extremely seriously, and we believe that other generators take the same view, and that strategic withdrawal of availability is unlikely.

We also consider that the nature of the CPM (including the ex-post capacity pot element of the mechanism) serves to remove the incentives to economically withdraw plant because, as the RAs pointed out in the presentation on 18th January, such withdrawn plant loses CPM revenues which are then re-distributed to the benefit of its competitors. Synergen believes that economic withholding highly unlikely, and that should any such activity occur there are specific remedies available.

Consequently, Synergen does not take the CEPA view in section 3.8 that "unless concentration in generation declines through structural change, intervention through the BCoP and DCs will still be appropriate" although we agree with the statement in the conclusions section that "it is therefore likely that there will be an ongoing need for robust market monitoring and bidding principles".

2.4 Assessment of Market Power Mitigation Measures (Section 4)

Synergen has provided detailed comments on the main elements of the market power mitigation components in its response to the RAs' Question 1 in SEM-10-084, and this broadly covers our observations with regards to section 4 of the CEPA paper. In short, however, Synergen believes that:

- The BCoP should remain for the time being but with specific sunset criteria relating to concentration measures and to broader questions of creating a level playing field between SEM based generators and generators based in markets which are increasingly interconnected with the SEM. Synergen wishes to see a continuing emphasis on the BCoP as a set of principles rather than rules.
- Synergen accepts that DCs provide contract volumes into the market and provide a disincentive to engage in strategies such as economic withholding. However, we believe that the experience of the market to date suggests that it may be time to move away from the RAs' "belt and braces" approach and discontinue Directed Contracts as an SEM market power mitigation measure.
- Synergen supports a well resourced and active MMU.
- There is no reference to Synergen's own legacy ring-fencing in the CEPA paper, notably under Option A. We are a wholly owned subsidiary of ESB International Ltd (ESBI) which is subject to strict ring-fencing conditions which mean the Synergen business must be operated completely independently from ESBI's independent generation businesses as well as from the regulated ESB businesses. Synergen views its ring-fencing as excessive, the conditions that led to the these licence conditions originally being put in place have been superseded by the present SEM competitive and regulatory structure.

Regarding the CEPA conclusions (section 4.9) Synergen considers that the case for removing horizontal ring-fencing is broadly similar to the case for removing vertical ring-fencing. The BCoP ensures a separation of ownership structure from bidding into the SEM and thus the case for retaining ring-fencing is limited. In particular we consider that the ring-fencing conditions in Synergen's generation licence should be removed.

2.5 Contract Liquidity in the SEM (Section 5)

In section 5.7, CEPA refers to NDC premiums over DCs and possible causes of this. Synergen notes that these differentials may not be due to overpricing of NDCs, but rather underpricing of DCs, a possibility which exists in addition to the explanations offered in the paper.

Regarding the CEPA observations on information provision (section 5.9) Synergen supports investigating further the possible additional elements of market information that are set out on page 64 of the paper.

2.6 Policy Options (Section 6)

In the CEPA paper Dublin Bay Power is treated as part of ESBI despite being strictly ring-fenced from ESBI, and this was confirmed by CEPA in response to a Synergen query at the 18th January workshop. This is of concern to Synergen since, under Option A, the paper clearly states that there would be no further removal of ring-fencing between ESB businesses.

As noted earlier in this response, Synergen is not expressing a preference for Option A, B or C, but is commenting on CEPA's description of each option and the implications of each option from a market power perspective.

2.6.1 CEPA Option A

- Option A should include the removal of Synergen's ring-fencing licence conditions which would allow it to be integrated with ESBI.
- DCs need to be reformed (s6.4.2) but the reforms could be more wide ranging than set out in the CEPA paper. Alternatives which place more emphasis on liquidity would, in practice, also place a contractual break on the incentives to drive up SMPs. We believe that such a liquidity approach would be preferable to CEPA's Option 1 (page 79).
- Option 2 (page 80) would be commercially prejudicial to Synergen's long-standing contractual commitments and we do not support it.
- Synergen supports consideration of further transparency (s6.4.4) on the proviso that information made available should not be commercially sensitive. (Synergen has expressed its concerns regarding the reporting of MMU investigations in our response to SEM-10-085.)
- Synergen does not believe that there would be any rationale for any structural changes to promote competition under this scenario.

2.6.2 CEPA Option B

- Synergen does not believe that a stricter bidding regime should apply to a horizontally integrated ESB or any other SEM generation business. It is important that the BCoP provisions are common across all participants and Synergen can see no rationale for a discriminatory application of the BCoP. Further, Synergen does not believe that a more rigid BCoP applied to all generators is either necessary or in line with the market power mitigation strategy objectives.
- Synergen does not believe that any structural measures would be required to address market power under Option B.
- Synergen does not support either of the options highlighted with respect to increasing market liquidity i.e. a universal requirement on all generators to offer hedges (in addition to any DCs) or a market maker option.

2.6.3 CEPA Option C

Synergen does not consider that delivering a structural change (through the removal of some legacy ring-fencing provisions) should require a remedy that is itself a structural solution. As stated elsewhere Synergen believes that the wholesale market integrity is adequately protected by the BCoP and MMU in broadly their present form – we accept some enhanced MMU role may have benefits but the BCoP should remain as is until any sunset provisions are developed for the BCoP and crystallise.

3 Comments on Workshop Discussions

The RAs stated at the workshop on 18th January that the SEM incorporates a number of market power mitigation measures in place, viz.: the SRMC bidding principles (via BCoP); DCs; ring-fencing; the MMU; local market power mitigation measures; and revision of prices post event.

3.1 SRMC bidding

While Synergen accepts that this remains a feature of the SEM for the time being, it is important that it does not become any more prescriptive than now and that any changes should serve to move the emphasis from “rules” to “principles”. We have some concerns:

1. sun-setting conditions should be set out by RAs;
2. increased interconnection makes it discriminatory between interconnected gencos such as SSE and purely SEM-based gencos;
3. increased wind penetration means many gencos within the SEM are not subject to SRMC bidding;
4. the ever present possibility of changes to the CPM and/or its implementation mean that SRMC plus CPM cannot be relied on to fully compensate generator costs in the SEM.

Under Options B and C there is no rationale for making the BCoP more stringent as:

(a) regardless of ownership all generation units bids in the same manner so bids under a generation monopoly would be equivalent to an atomised structure and there is no evidence presented to suggest the contrary;

(b) increased prescription would be contrary to the intent of the BCoP;

(c) increased restrictions would increase regulatory risk;

(d) any more restrictive bidding could not be confined to ESB as this would be discriminatory.

3.2 Directed Contracts (DCs)

These should be replaced by liquidity undertakings (maybe phased in) under options B and C. Under Option A the analysis seems to suggest that have a limited effect on market power metrics. The RAs should consider a greater range of products – notably hedges against peak prices and outage cover hedges for gencos.

3.3 Ring-Fencing

Relaxation of some aspects of the market power mitigation would also include arguing for the removal of the ring fence between ESBI and Synergen. Option A should allow for the removal of the Synergen ring-fence.

3.4 Market Monitoring Unit

Synergen consider that an effective MMU is the single most important plant of an effective market power abuse mitigation strategy. Synergen thus fully supports its ongoing activity, although we do not believe that its scope should be expanded unless there is a clearly made case for doing so.

3.5 Local Market Power Mitigation Measures

These remain a valid tool in principle, even if they have not been required to date.

3.6 Revising Prices Post Event

Synergen does not believe that the ways in which this may operate in practice are established. Consequently, it appears highly unlikely that the RAs could use this measure (which is not explicitly set out in generation licences, the T&SC or other market documentation) in practice.

4 Synergen Responses to Consultation Points

Consultation Point 1. ***Do the objectives and criteria for the Market Power Mitigation Strategy remain appropriate today and for the foreseeable future?***

Synergen agrees with the objectives set out in Section 2.1 of the CEPA paper and that these remain appropriate for the foreseeable future. Regarding the criteria for the design of market power mitigation measures, we have the following comments:

- effectiveness: we believe that measures should be effective at mitigating the abuse of market power rather than the existence of market power;
- retention of the profit motive: Synergen agrees that this should be a design criterion but believes that the RAs need to actively consider how to give effect to this. Rewards to generators depend on the combination of revenue streams including the CPM and Ancillary Services. The amounts of both the CPM and AS revenue "pots" are driven by the RAs and are subject to changes in their determination and allocation as a consequence of ongoing regulatory consultations. Synergen considers that there should not be unreasonable restraints placed on generators to seek to recover their total costs through the combination of revenue streams available, subject to not abusing any market power.
- regulatory efficiency: Synergen believes that any changes to the existing approach should be subject to a demonstrated, and published, cost benefit test. This should include any changes to the role of the MMU.
- ability to sunset – Synergen does not believe that the existing market power measures should continue for the foreseeable future; the RAs should state the conditions under which the existing market power measures would cease to be required. This exists in a de-facto manner with directed contracts, but not with the BCoP.

The question posed related to the objectives and criteria adopted for market power mitigation measures, Synergen believes that it is also necessary to address whether the measures adopted to meet these objectives and criteria are necessary.

Synergen's high level view is that some of the market mitigation measures should be relaxed under Option A and not increased under Options B and C. The RAs have made clear their view that under all options, the BCoP stays. If this is the case, then Synergen believes other elements of the market power mitigation measures should be revisited as the "belt and braces" approach established at SEM Go-live is unnecessary.

Consultation Point 2. ***Will the new interconnector facilitate more competition from Great Britain? If so, what will be the impact on the appropriate market power mitigation strategy?***

It is not clear what "competition" means here. Is it:

- That the market is structured in line with competition metrics? or
- That parties compete on a level playing field?

The new interconnector will facilitate more competition with Great Britain but the outcome of interconnection on competition in the SEM depends on the predominant nature of the flow and whether the flow is two ways. Inflows could dilute the market power of SEM generators in the market segments the interconnector volumes competed in but inflows could also increase the market power of the parties trading across the interconnector.

The converse is less certain as outflows would only increase the market share of a participant if it was providing proportionally more of the additional volumes. In that case an import into the SEM could increase the market share for those **outside** the BCoP. This has discrimination implications.

Consultation Point 3. ***It would be helpful if market participants could explain why they believe demand for hedging products in the SEM exists, and how this demand is not addressed by alternative hedging options, such as through fuel markets.***

In gross electricity pools generators and retailers wish to hedge the market price risk they incur. In the SEM, although retailers provide fixed prices to customers to a very high extent and seek to back off as much price risk as possible, in reality customer and load shapes do not match, and retailers inevitably have some pool exposures. Although volatility is low compared to other markets, the SEM's mandatory nature and marginal pricing regime impose complementary risks to retailers and generators and thus drives hedging. Retailer smoothing means that the capacity payment is not a hedgeable price element and the BCoP serves to limit price volatility. This does not remove the desire to hedge pool price, however, so demand for hedging products remains.

Consultation Point 4. ***In what way could DCs be reformed in order to promote contract liquidity while also mitigating market power? Do you see merits in replacing the HHI with the RSI in determining DC volumes?***

Synergen considers that contracts directed by the RAs are less desirable than other liquidity measures and are somewhat of a blunt instrument for market power mitigation. Market segmentation (baseload, mid-merit and peaking) is inadequately reflected in DCs and instruments such as cap contracts are not available. Liquidity requires market depth, information provision, and quality of counterparty. The administered nature of the SEM (notably the BCoP) mitigates against the development of liquidity. DC prices are set by the RAs, possibly with objectives other than pure economic pricing, which does not assist in developing a true secondary market price.

Synergen believes that a liquidity undertaking would reduce any incentives for the generator providing it to bid up in the Pool to increase revenues. Generators subject to such an undertaking may not in the short term be free to solely offer contracts at any price of their choosing, and there may be a need for such contracts (both form and price) to be subject to a series of agreed auditable principles (a loose version of the BCoP).

Regarding the relative merits of HHI and RSI, Synergen believes that both metrics are subject to a discretionary choice of trigger value. We consider that the RSI may be more subjective in this regard – as evidenced by the paper, which clearly demonstrates the extent to which concerns about market power depend on the trigger value adopted.

Consultation Point 5. ***Does the recent removal of the EPO condition from ESBCS for business customers and the earlier EPO removal from NIEES for customers with an annual demand above 150 MWhs, together with the removal of ring-fencing between ESBCS and ESBIE, negatively impact on the SEM spot or contract markets? If you consider that it does, are there any replacement conditions required in the SEM and what should they be?***

Synergen has no evidence of the spot or contract markets being distorted by the removal of the EPO for business customers and the removal of the ring fence between ESBCS and ESBIE.

Consultation Point 6. ***Do you consider that the planned forthcoming removal of the EPO for domestic customers in Ireland will have an adverse effect on competition and liquidity in the SEM spot or contracts market? If so, what replacement would you recommend for the SEM? Would the removal of the EPO from NIEES for customers below 150 MWh per annum in NI have a similar impact – and if so, what replacement would you recommend?***

Synergen does not consider that the removal of the EPO for domestic customers will negatively impact the SEM spot or contract market.

Consultation Point 7. ***What if any, implications for competition/ end customer do you see arising from ESB's proposed reintegration:***
a) Horizontally,
b) Vertically,
c) Horizontally & Vertically.
What, if any, new measures would you recommend be put in place for each of the above forms of integration?

Our comments relating to this question are limited to consideration of Synergen being integrated with other ESB businesses. We can see no reason why Synergen's integration with the rest of its parent company businesses would have an adverse impact on competition in generation, retailing, or on customers.

Synergen does not consider that the horizontal re-integration (of Synergen) would have a notable impact on wholesale competition. Synergen operates in the base-load sector of the market and bids in accordance with the BCoP - this would not alter as a consequence of the ownership and/or control of the plant. Synergen's wholesale bids and retailer contracts are in line with commercial contracts which would not change with integration.

Consultation Point 8. ***Would further divestment by ESB encourage deeper competition in the wholesale market?***

The BCoP means that the ownership of plant is not a material consideration in terms of how that plant is bid into the market. There is thus no compelling case to suggest that competition would be improved through ESB divestment given the current regulatory regime, unless any divested plant had a cost structure different to ESB PG, or made thermal efficiency gains through further investment.

Since ESB is currently restricted from competing in the SEM it could be argued that removing those restrictions would increase competition.

Consultation Point 9. ***What are the current incentives on generators and suppliers to offer and purchase contracts? Are there any impeiments to trading contracts? Do you agree with mandating all generators to offer contracts and/or to become market makers? If not all generators, what criteria would you use for mandating generator to offer contracts or to become a market maker?***

As with any gross pool, hedging contracts provide both generators and suppliers with a valuable mechanism to manage the price and volume risks associated with a mandatory spot market. Stabilising purchase and sale prices (for retailers and generators respectively) is balanced off against the price / volume risk if hedge volume exceeds market volumes, and contract price is less than pool price for a generator. Synergen considers that the issues associated with hedging are reasonably set out in the CEPA paper and require little further expansion.

Synergen does not agree with mandating all gencos to offer CfD contracts as trading in the SEM is already mandated. Further obligations on how to trade are an infringement on commercial freedom and contrary to the long term development of trading through the evolution of willing buyer/seller secondary trades. The pool price should be an available option to take as a revenue source for generators. Synergen considers that “market making” is analogous to mandating contracting, and thus the same arguments broadly apply.

Synergen believes that:

- mandating contracting (in principle) should **only** apply to parties with market power (within specific market segments);
- undertakings to contract (be they by liquidity undertakings or mechanisms such as market marking) are preferable in terms of engendering liquidity than mechanisms such as DCs.
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Consultation Point 10. ***What product types and in what proportions should a minimum specification market maker offer? What eligibility restrictions should there be to trading with market makers?***

Synergen does not believe that mandated market-making is desirable but that, if market-making were to be mandated by the RAs, contracts should be base-load, mid-merit and peaking and should be tied into market power metrics in each segment. In terms of purchasing, there should be no restrictions and contract prices would have to be market-based, not below market prices. Allocating contracts to suppliers pro-rata to market share suggests that they are particularly desirable, i.e priced below expected market prices. Given this, generators should also be able to purchase hedge contracts, as indeed should financial players.

Consultation Point 11. ***Do you agree with the CEPA analysis of the ability of structural remedies to address the competition problems presented by the hypothetical structural scenarios outlined in section 6 of the accompanying paper?***

CEPA suggests that allowing structural change generally requires behavioural remedies – and this is problematic. For option C CEPA suggests a structural change following a structural change (i.e. the spun off genco of Dublin Bay / Moneypoint post Option C). Synergen agrees with CEPA that there is no point creating a structure that then requires a structural solution, and though we note that the CEPA illustrated spun-out genco is hypothetical, Synergen opposes such an outcome.

Consultation Point 12. ***Will ESB's liquidity proposal be effective in assisting contract liquidity in the market if it is allowed to vertically and horizontally integrate? Will this proposal facilitate competition in the wholesale and retail market? If so, why? If not, why not?***

Synergen considers that, given the BCoP, ESB integration will not change any wholesale market price outcomes and ESB's liquidity proposals would seem to be a positive suggestion.

Synergen believes that given the BCoP the issues of market power abuse mitigation and liquidity are separable, and the existing DC arrangements should be re-visited.

Consultation Point 13. ***Will increased wind penetration affect demand for contracts and the need for market liquidity?***

The variability of wind will drive uncertainty in conventional volumes and may drive changes in price profile i.e. prices may become more volatile, but Synergen has not investigated this through modelling. We think that the demand for contracts would not change markedly, but the willingness to offer them (and the manifestation of risks in contract premiums) could lead to divergence between SMP and contract prices as the price / volume risk to generators becomes more uncertain.