Single Electricity Market Committee

SEM - Market Power & Liquidity – Consultation (SEM 10-084)

ESB Submission

16th December 2011

EXECUTIVE SUMMARY

While ESB welcomes the proposed decision by the Regulatory Authorities to permit horizontal integration of ESB's Generation businesses we are very disappointed that the SEM Committee is unable to approve vertical integration – or partial vertical integration at this time.

Horizontal and vertical integration is the normal mode of operation of electricity supply and generation companies across both Great Britain and Ireland and indeed in many other jurisdictions. The rationale behind this preferred choice is self evident as it enables participants to achieve a) the lowest cost of operation through the removal of duplication; and b) the most effective means of managing trading risk in the market place on behalf of customers. The unavailability of integration to ESB significantly reduces our ability to achieve efficiencies in both of these areas and we believe is an unnecessary burden given the market development that has taken place since the current arrangements were put in place at the outset of market deregulation some twelve years ago.

In 2000 when the electricity market was initially deregulated, CER chose to implement the current form of generation and supply separation as a regulatory mechanism to encourage new entry in the market place and drive an agenda for competition. ESB accepted these constraints as proportionate to our position at that point in time and we have at all times abided by them and voluntarily provided constructive input to the development of a competitive market initially in Ireland and more recently across the SEM as a whole. Specific initiatives which we have championed in that period included

- Discounted VIPPs to enable competitors to compete customers away from ESB;
- Development and implementation of market opening systems to ensure that customer switching was seamless and uncontroversial;
- Offtake contracts to secure the entry of new Generation capacity;
- Market liquidity contracts under SEM through NDC and PSO-related arrangements; and
- Delivery of an OTC Contract platform enable further bilateral trading.

These initiatives have been supported by ESB because we believe that the development of a competitive market across the Island will deliver outcomes which are in the best interest of customers as a whole. In addition we have always recognised that a competitive market will drive change and efficiency within our own business which will position the company on a sustainable footing and deliver quality and price efficient services to customers.

In the period since 2000 the electricity market on the Island has been transformed with significant competition from substantial companies such as BGE, SSE, AES, Endesa and Viridian. The market will experience a further step change in 2012 when the East West interconnector opens the Irish market to even greater degrees of competition particularly from SSE and AES who have a significant footprint in both Great Britain and the SEM.

Given the degree of change which the market has undergone since the separation arrangements were first implemented 12 years ago, it is now timely to allow ESB to plan and implement a scheme for full integration of our Generation and Supply business to enable ESB reduce costs and implement a best practice risk management structure. This will further improve ESB's product offering to customers and provide a renewed dynamic towards further efficiency both within ESB and importantly within our competitors. Furthermore, while we recognise that market size and the relative size of our competitors raise specific issues around liquidity, we remain convinced that an integration scheme can be implemented in a manner which ensures that competitors are not unfairly disadvantaged but equally provides greater incentives for competitors to compete and provides a means of delivering integration benefits of increased cost reduction and risk management to all electricity customers on the Island of Ireland.

Whilst the operation of the BCoP is such that certain cost savings in the generation area do not feed through to the SMP. Horizontal Integration will result in a greater level of DCs than is currently the case and, as a direct consequence of Horizontal Integration, these additional DCs will provide direct cost benefits to all Suppliers and through to the end consumers.

It is for these reasons that ESB welcomes the decision by the Regulatory Authorities to allow Horizontal Integration of ESB's Generation facilities from October 2012. Equally we are very disappointed that Vertical Integration is not being allowed for now. We request that immediately upon the completion of Horizontal Integration that the Regulatory Authorities re-engage with ESB to explore further the benefits of Vertical Integration. In this respect we remain of the view that the Partial Vertical Integration model proposed by ESB provides a useful template for such a discussion. We note that the CEPA report confirmed the reasonableness of the quantum of regulated contracts which ESB proposed would emerge from this model and CEPA's general view that further engagement with ESB on vertical integration should be pursued by the Regulatory Authorities.

In our response to the draft decision ESB wishes to make comment in five areas, the draft decision not to allow Vertical Integration for now, the draft decision to allow Horizontal Integration, and the comments from the RAs and CEPA in relation to DC offerings, liquidity and market power.

ESB appreciates that the issues being addressed by the SEM Committee in this workstream are complex and ESB remains very supportive of the matter being brought to a conclusion as soon as possible.

ESB COMMENTS ON THE SEM COMMITTEE'S DRAFT DECISION

Vertical Integration

ESB is very disappointed that the SEM Committee is planning not to allow either the ESB full vertical integration or partial vertical integration (PVI) options for now.

From our reading of the CEPA review of ESB's PVI proposals, and without having had an opportunity to engage with CEPA on this matter, ESB is of the view that CEPA have overlooked a number of key facets of ESB's proposal that would resolve CEPA's concerns.

ESB remains of the view that the PVI proposal resolves a number of market power and liquidity issues for the market whilst concurrently allowing ESB to drive out further cost reductions and business efficiencies to the benefit of all electricity consumers. Once the SEM Committee decision is finalised, ESB suggests that there would be merit in engaging with CEPA and the RAs to explain how the PVI proposal resolves CEPA's concerns.

In the meantime, ESB welcomes comments from CEPA such as "ESB's new proposal….does offer a larger volume of contracts and an opportunity to heavily regulate these contracts with a view to improving contract market liquidity" and acceptance that "the 50% figure (for the regulated wholesale contract portfolio) proposed by ESB does not look unreasonable". It is also welcome that CEPA's analysis of the PVI proposal concludes that "the average RSI scores would not be of great concern (and) when we look at the percentage of hours that the RSI would be below the threshold used in our previous report,1.2, we see that ESB's proposal gives the best RSI scores of the three options" and that "solely on the basis of this quantitative analysis, we cannot see any major market power concerns with the overall proposed approach. "

We appreciated CEPA's summary that "this proposal could be a reasonable first step to full vertical integration, and on narrow quantitative competition metrics alone, a 50% integrated ESB would not be of great concern relative to the current ESB structure. There are benefits to vertical integration, and these could include lower prices for consumers. However, the benefits have not been properly set out or quantified. We recommend exploring further with ESB the actual potential for cost savings from *vertical* as opposed to *horizontal* integration. "

ESB would be happy to set out and quantify the benefits to consumers from vertical or partial vertical integration and would like the opportunity to discuss this further with CEPA and the RAs once the decision on horizontal integration is confirmed.

Horizontal Integration

ESB welcomes the SEM Committee's draft decision in respect of Horizontal Integration of ESB's generation businesses.

In this regard, ESB notes that "the SEM Committee is satisfied that there has been no significant market power exercised in the spot market to date" and that although there would "still be certain hours/scenarios when the RSI … suggests market power potential", "CEPA's spot market modelling analysis for 2015/20 indicates that … ESB's market power would not be at levels of concern *on average*".

ESB notes that CEPA had previously concluded "that the Bidding Code of Practice (BCoP), together with the monitoring by the Market Monitoring Unit (MMU), has been effective…" and that "whilst the BCoP remains in place… the operational horizontal separation of ESB seems to have little value in promoting competition, whilst adding some cost to ESB, and thus an operational integration should be considered."

ESB strongly agrees with this, with CEPA's conclusion that "overall, we see benefits in the form of efficiency savings in allowing operational horizontal integration, with limited risks so long as the BCoP remains in place…". and with the SEM Committee's intention to allow the horizontal integration of ESB generation units.

ESB notes that CEPA's report (on ESB's Partial Vertical Integration proposal) comments on the value of horizontal integration to the extent to which cost savings can be passed on to the end consumer. ESB believes however that any proposal which enables the reduction of cost and risk within the value chain should have the support of the Regulatory Authorities – the only legitimate regulatory concern should be ensuring that other parties are not unfairly disadvantaged and CEPA have identified no such concerns in their support for Horizontal Integration of ESB's generation businesses.

On the contrary, the decision to enable horizontal integration will enhance the risk management capability across the market as a whole and, whilst the operation of the BCoP is such that certain cost savings in the generation area do not feed through to the SMP, ESB argues that it is of general benefit that costs and duplication should be driven out of the electricity value chain.

Furthermore, ESB accepts the RA's view that Horizontal Integration will result in a greater level of DCs than is currently the case and, as a direct consequence of Horizontal Integration, these additional DCs will provide direct cost benefits to all Suppliers and through to the end consumers.

In summary, ESB agrees with the SEM Committee draft decision to allow the horizontal integration of ESB generation units and believes that this will provide direct cost benefit to end consumers.

Liquidity

ESB welcomes the SEM Committee's acknowledgement of "the recent developments in contract liquidity" including PSO-related CfDs, regular NDC auctions including for short-term products, and the new Tullet Prebon OTC trading facility.

ESB has been instrumental in each of these developments, hosting the PSO-related CfD auctions on behalf of the RAs, voluntarily and unilaterally increasing the frequency of NDC auctions and selling longer term products to meet the needs of Suppliers, and driving the development of the OTC platform with Tullet Prebon and other market participants. ESB has delivered on all its commitments in respect of wholesale liquidity and has driven progress in this area.

However, we remain concerned that ESB is the only market participant selling wholesale contracts. Whilst this situation remains, ESB is concerned that the RA's mistake ESB's willingness and cooperation in this regard for market power. The RAs clearly want ESB to offer more liquidity and ESB has been responding positively. However, the more contracts ESB sells, the greater the perception that ESB has a dominant position in this contracts market and the greater the sense of the other market participants that market liquidity is an issue for ESB alone.

We are particularly concerned that, because DCs provide a significant chunk of wholesale contract liquidity, there is a temptation to see them as a means to resolve liquidity issues. ESB welcomes the confirmation "that the primary purpose of DCs is as a market power mitigation mechanism rather than as a liquidity measure per se". But ESB is extremely concerned that DCs are an easy lever to reach for in relation to liquidity and comments such as "from a liquidity perspective, the RAs consider that the current annual offering of DCs now work well from a liquidity perspective" and references to "the lowering of the HHI threshold" in the event of "liquidity levels significantly falling" intensify that concern.

It is clear that the DC process was established for the purpose of SEM market power mitigation. It is important that the SEM Committee is clear, in respect of the DCs that ESB is obliged to offer, ESB does not determine the volume of contracts sold, nor when these contracts are sold, nor the types of product sold, nor the price, nor who these products are sold to. In effect, ESB has no control whatsoever over these contract sales and, by extension, has no control over the underlying generation capacity from which these contracts derive and the use of DCs as an enduring mechanism to resolve market liquidity issues would be entirely inappropriate.

We note the RA's view that 'liquidity is generally best developing organically through industry/market initiatives.' rather than through intervention. However, ESB is the only market player developing initiatives and, if this continues, then some direct intervention impacting all generators must be required. ESB is particularly concerned that this paper could give comfort to other market participants that liquidity is an issue solely for ESB and that if it doesn't improve organically (which requires all participants to bring something to the solution) then ESB might be required to resolve the matter with additional DCs. It would be helpful if it were clarified that this was not the case in order to promote the involvement of all market participants in developing organic liquidity initiatives.

Given that DCs effectively neutralise ESB's capability for the exercise of market power potential, the imposition of additional DCs on ESB, over and above those required to bring ESB's market power down to an acceptable level, would disproportionately disadvantage ESB, would be discriminatory, and would signal a departure from regulatory objectivity.

In ESB's paper on liquidity in (July 2010) we pointed out that the existence of DCs actually serve as an inhibition to the development of a wholesale contracts market. The fact that benchmark products in the form of DCs (and PSO-related CfDs) are made available at the behest of the RAs and are priced with no risk premium, reduces demand and undermines prices for CFDs. The more the RAs look for regulated solutions to liquidity, the less the likelihood of a deep market developing.

ESB's modelling confirms that increased levels of DCs will be required following horizontal integration and ESB accepts this as part of the market power mitigation process. ESB also proposes that ESB, the RAs and market participants discuss the appropriate timing of the sales of such contracts as it may not be in the best interest of the market for this additional quantity to be sold all in one short window. ESB will separately bring constructive proposals in this regard for the consideration of the RAs and the market. .

Directed Contracts

In the draft decision paper the RAs propose retaining the HHI Threshold at its current value of 1,150. ESB strongly believes that this threshold should be raised.

In setting out the reason why the threshold should be increased, it is important to reflect again on the object of the threshold and the principles guiding the appropriate value for it. The original SEM paper "Directed Contract Quantification Methodology Decision Paper" (AIP/SEM/208/06: 8th December 2006), provides a very useful discussion on HHI threshold. In this paper the RAs state that they are seeking "the level of Directed Contracts that is the minimum needed to ensure a competitive market" "but without the risk of enabling market power". These are important principles as they confirm that the HHI threshold and consequential Directed Contracts are primarily a means of addressing market power rather than a means of delivering contract liquidity which the RAs rightly recognise should be driven by competition. Of course the fact that DCs do indeed provide liquidity is an added advantage however it should not deflect from the primary purpose of the DC process and the HHI threshold.

In its report CEPA identify that a HHI of less than 1,000 is deemed to indicate an unconcentrated market, while 1,000 to 1,800 would indicate a moderately concentrated market. It is clear therefore that the RAs, when adopting the threshold of 1,150, took quite a conservative view. In the decision paper at the time the Regulatory Authorities considered factors that would determine the appropriate HHI threshold. Specifically the paper stated that

a. As a consequence of the low elasticity in spot electricity markets “the Regulatory Authorities would hesitate to use an HHI index above 1,500”
b. The large contribution to the HHI by one company would tend towards a lower threshold than would be the case otherwise
c. Especially at the outset, the RAs believe it essential to ensure that market power will not affect the spot market, again tending towards a lower level
d. While adopting the NERA ring fencing recommendations, the RAs stated that the NERA ring fencing recommendations will be adopted for the purpose of calculating the actual HHI for the sector, the RAs decided that this will be “tempered by using an HHI threshold lower than might otherwise have been applied”

It is clear from the evidence base presented by CEPA and the commentaries by the RAs and the MMU that market power has not been exercised in the period to date and therefore the spot market price has been a reliable indication of an efficient electricity price. Accordingly the concerns expressed by the RAs in point c) should be revisited and would therefore result in an increase in the HHI threshold. Taking point d) given the decision to allow Horizontal Integration of the Generation business, the actual HHI calculated, for the purposes of determining the volume of DCs to be offered, will be based on the integrated business, there is therefore no longer any rationale for tempering downwards the HHI threshold. We note that CEPA acknowledge the case for a higher threshold level.

In terms of the impact on the volume of DCs which would be available in the market for a revised threshold. ESB models for typical scenarios of fuel and demand indicate that the volume of Directed Contracts (particularly contracts for shape) required from ESB generators in total, with a HHI threshold of 1,300, will be greater than currently required from Power Generation under a threshold of 1,150.

On this basis, it is clear that consideration should be given to increasing the HHI threshold towards 1,500.

Note that ESB has previously provided a separate paper to the RAs on this matter ad we would be happy to submit it as part of this consultation.

Market Power

ESB welcomes the SEMC's conclusions in respect of market power. ESB believes and the MMU reviews demonstrate that the market is working effectively and that the current market power mitigants, the BCoP, DCs and the MMU are proving very effective.

ESB is indifferent as to whether RSI or HHI is used in order to measure market power. From a practical point of view, whilst DCs are required, the HHI is probably a simpler method to be used.

ESB is concerned that the concept of market power in the *wholesale or contracts* markets is raised in the paper (for example, "…this exercise of contract market power by ESB…") without being properly defined and without being generally understood. ESB is of the view that the effective mitigation of market power potential at the spot market level effectively mitigates any contract market power potential even in the absence of other external market power mitigants which do exist.

ESB would like this matter (of wholesale or contract market power) to be explored and understood by the RAs and the industry because, absent this understanding, incorrect and inappropriate conclusions are being drawn with the risk that decisions are being based on perceptions rather than reality.

CONCLUSION

ESB welcomes the proposed decision by the Regulatory Authorities to permit horizontal integration. This will allow ESB to remove costs and duplication and, through DCs, will directly reduce costs to end consumers.

We find the proposal not to approve vertical integration or partial vertical integration at this point very disappointing, given the quantitative findings in its favour within the CEPA report. We note the recommendation by CEPA that further information on the proposal be elicited and we look forward to those discussions, following the implementation of the forthcoming decision.

We agree with CEPA's broad findings that the regulatory measures deployed in the SEM are working and we remain committed to continuing to engage with the market in pursuing contract products to meet the needs of the industry.

We look forward to a timely decision from the RAs.