

**Power NI Energy Limited
Power Procurement Business (PPB)**

I-SEM Detailed Design

**Market Power Mitigation
Discussion Paper**

SEM-15-031

**Response by Power NI Energy
(PPB)**

19 June 2015.



Introduction

PPB welcomes the Regulatory Authorities engagement with market participants in the development of the I-SEM and particularly welcomes early engagement and the opportunity to respond to the Discussion Paper in relation to Market Power Mitigation in the I-SEM.

General Comments

Market Power has been a significant issue and challenge in the SEM, notwithstanding the strongly regulated nature of the market. The opportunities for the exploitation of market power will be greatly increased in the I-SEM given the increase in market areas (e.g. 3 energy markets instead of 1) and the move towards market arrangements rather than regulated arrangements for the CRM and Ancillary Service markets. In addition, forward market liquidity is likely to be even more critical to participants' risk management strategies and market power in such financial markets will also need to be addressed.

PPB's response to the consultation on the HLD of the I-SEM¹ and in particular the Baringa attachment that was included with the response² (that considered how to promote forward liquidity and mitigate market power in the I-SEM), highlighted our concerns on the issues of forward market liquidity and market power. The Baringa report identified a range of measures that could be employed to help address these issues and which we believe remain worthy of consideration.

The Viridian Group has also commissioned a report from NERA³ to review the Discussion paper on I-SEM Market Power Mitigation. We draw on its conclusions in this response and attach the NERA paper in support of this response.

¹ SEM-14-008

² Titled "Promoting forward liquidity and mitigating market power in the I-SEM"

³ Titled "Review of Market Power Principles for the I-SEM"

Responses to the Specific Questions raised in the Consultation Paper

Section 2.2

Q1 Are the market power concepts and examples provided appropriate and sufficient for I-SEM?

The market power concepts identified seem generally sufficient in relation to potential generator activities in the spot markets. However, they don't identify the scope for actions that could be employed by dominant vertically integrated participants across a portfolio of conventional and renewable generation, and retail demand.

They also fail to fully consider actions in other markets including the Forward, Ancillary Service and Capacity markets and while the concepts may be broadly similar, the methods of exertion may be subtly different.

Q2 Are the potential constraints on market power referred to in this section appropriate for I-SEM?

The success of the potential constraints on market power may be limited without wider mitigation measures. For example, while forward hedging is voluntary and hence either party can decide not to participate, this is likely to break down in times of commodity price volatility and when smaller participants may have much more difficult choices, for example from the risks of not contracting. We do not therefore agree that the potential for market power is lower in the financial markets.

The potential for competition, particularly in electricity generation, tends to be more limited where substantial capital is required to invest, lead times to entry are relatively long and the asset lifetime is long. Such high entry barriers limit the scope for the threat of new entry to provide a limit. Further a more significant concern for the I-SEM is the issue of price suppression that could be employed to increase such entry barriers (and for reasons that may not be profit-orientated).

Buyer power could in theory help mitigate market power but may not provide any assistance in the I-SEM where one of the primary concerns is a dominant supply business, and where the dominant generation and supply businesses have a common semi-state parent.

Section 2.3

Q3 Given the emerging I-SEM design, including closer integration to European electricity markets and a number of energy trading timeframes, what is the appropriate geographic market(s) and/or trading period(s) definition for the measurement of market power and determination of a mitigation strategy in I-SEM?

As identified in the NERA paper, market coupling is unlikely to expand the geographic market for any of the market areas in the I-SEM.

Q4 Are the various (other) market design issues referred to in this section and their potential impacts on market power captured appropriately and fully?

In relation to the wider emerging design of the I-SEM, many of its features increase the market power potential for larger portfolio participants. For example:

- the bid structures in Euphemia are likely to provide greater scope for portfolio generators to manage their risks while increasing the risks for smaller competitors, the IDM design may provide enhanced opportunities to trade out risks for portfolio participants, and operation in the BM may be more favourable for large portfolio players. The various market complexities that favour portfolio players and the increased number of markets in which to participate are likely to increase the scope for market power to be exercised and additionally, may make market power more difficult to identify.
- Similarly, the differences in trading periods and how settlement applies to less granular DAM trades could increase the scope for market power (e.g. depending in the detailed design, IDM trades may be required to help manage shape imbalances arising from the DAM outcomes that may not be feasible or match the demand profile but exploitation of market power could greatly increase non-dominant participants to imbalance risk, and where that BM pricing is also exposed to market power).
- The form of offers into the DAM are very different to the SEM and will require mid-merit generators in particular to seek to reverse engineer bids to reflect how they consider they will be scheduled. However, they could be exposed to the bidding behaviour of larger players who have opportunities to smear risk over their portfolio with the ability to more

easily manage infeasible positions through trading across their portfolio in the IDM.

- The auction processes proposed for both the CRM and DS3 are likely to provide high potential for market power. This could be manifested in both the auction processes as well as in the competition for delivery of the services (e.g. if under DS3 services are only paid for when utilised).

Section 2.4

Q5 What is the appropriate approach to measuring market power when developing a mitigation strategy for I-SEM?

We do not consider any single measure can be identified as the definitive measure and believe a range of measures may usefully be employed in the measurement of market power. Further, it may well be that different combinations or subsets of the measures may be relevant to the investigation of market power in different markets or for different products.

Q6 Should the measure be determined at a snapshot in time or based on historical or potential future trends in market share (or both or all three)?

The measurement can only consider the circumstances prevailing at the time although clearly known and definitive future developments could be relevant (e.g. a divestment of capacity). We therefore consider the primary focus should be a snapshot of the present, although this may be informed to some extent by the historical evidence which may add some context to the consideration. Other than definitive known future events, we do not consider there is any merit in basing any assessment on speculative assessment of how situations may evolve and consider it would be better to consider sunset type arrangements that would trigger a re-assessment should circumstances change. The NERA paper provides further assessment on this issue.

Section 3.2

Q7 How effective have the SEM market power mitigation strategy and measures been?

The measures employed in the SEM spot market have generally been effective although the failure to employ any measures in the forward market has been a shortcoming.

Q8 To what extent is the strategy and measures applicable to I-SEM?

A number of the measures are not readily transposable into the I-SEM. The form of bids in the I-SEM are not conducive to the application of a bidding code of practice and the dynamics of the market are likely to make it very difficult for market monitoring to be effective. Directed contracts may be effective in that they reduce the scope for market power to be applied to forward market prices. However the forward market also needs measures to ensure overall forward contract volumes are not being restricted through for example, overly prudent volume offerings.

Q9 Are there other market power mitigation measures worth considering in the context of I-SEM? (See Appendix 2 for a review of a number of other European markets).

As we have previously promoted, a key measure that we considered will be essential in the I-SEM is market making measures that will likely be required for dominant generators and also potentially suppliers in the markets. Such obligations will be necessary in the forward market and also potentially in the IDM.

It is also worth considering measures that have been adopted in other markets although we would caution that any such measures should not just be lifted and shifted into the I-SEM but need to be carefully assessed to ensure they are appropriate for the specific conditions prevailing in the I-SEM.

Q10 What are the barriers to entry for non-asset backed traders in the SEM financial forwards market?

In energy markets to date, the primary asset-less traders have been the large banks. However, the changes in financial regulation has seen many of these entities withdraw from commodity and energy markets and hence it is probably unrealistic to expect any significant participation by asset-less traders in the I-SEM. The small size and peripherality of the I-SEM market

and the presence of a dominant generator and supplier are also likely to be market features that will act as a barrier to entry

Section 3.3

Q11 Are the principles of market power mitigation outlined in this section appropriate?

The principles generally seem appropriate although, as highlighted in the NERA paper, a key concern is the transparency of intervention and recognising the importance of minimising the scope of any regulatory discretion. NERA note that “*vague of arbitrary application of these principles will discourage market participants from acting in a competitive manner, as well as (or instead of) discouraging non-competitive behaviour*”. As a consequence any assessment will need to provide objective evidence for any proposed intervention, considering each of the principles.

Q12 How should these or other principles be applied in I-SEM?

We consider it is vitally important that the SEMC’s application of the principles ensures that rigorous assessment of proposed measures is conducted, taking specific cognisance of the I-SEM market conditions. This again reflects our view that measures that may function effectively in other markets may not function as effectively if merely transposed into the I-SEM and it is vital that measures are custom fitted for the issues and conditions that prevail in the I-SEM.