



# Response to the I-SEM Consultation Paper on Market Power (SEM-015-094)

Prepared for VPE/Energia

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# Agenda



## **Principles:**

- A. Review of “Key Principles” and the Current MPM

## **Proposals:**

1. Identification of Candidates for MPMs
2. SRMC as the Target for “Competitive” Pricing
3. Specific Problems with SRMC Pricing for Transmission Constrained Generation
4. The Forward Market and Vertical Ring-Fencing

# Findings and Conclusions



## ■ Conclusions on Principles

- For competition to thrive, MPM must set out **transparently** what (kind of) behaviour is prohibited, so as not to discourage competitive behaviour
- The success of the BCoP shows how any new MPM will need the same **flexibility**, to avoid Type 1 errors when facing a similar range of costs
- Letting **competition** set prices is preferable to **regulating prices**

## ■ Conclusions on Proposals

- 1)i) HHI and RSI indicate persistent market power (for 1 or 2 players), until 2024 at least, in **peak/stress hours** and in **capacity markets**.
- 1)ii) The Consultation Paper recognises the “SCP” framework (para 5.1.2) and Structural filters require further work on **Conduct** and **Performance**
- 2)i) Setting **competitive prices** is difficult for competition authorities. **Regulating prices** raises different questions, e.g. about cost recovery etc
- 2)ii) Prescriptive rules on SRMC pricing **will not promote efficient competition** and will deny consumers the services they want
- 3) Competitive behaviour in the **BM** can only be defined **in principle**, as in the BCoP, and not through **prescriptive formulae**, as in the Consultation Paper.
- 4) The **stated mandate** of the “**Forwards and Liquidity Workstream**” must cover market power (and vertical ring-fencing), as well as liquidity per se

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**Transparent, flexible application of principles will produce better outcomes for consumers than tightly prescriptive formulae for SRMC**

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# The five “Key Principles” are a good starting point for appraising MPMs



The Key Principles (para 8.3.1) acquire meaning through consideration of “Type 1” and “Type 2” errors (para 8.3.3)

- **Effective:** MPM should not fail to identify abuse (Type 2 error) and should also not hinder competitive behaviour (Type 1 error)
- **Targeted:** MPM should constrain dominant players but not impose a major compliance burden or otherwise hinder potential competitors
- **Flexible:** Rules must capture new forms of abuse, but must also permit all forms of competition behaviour
- **Practical:** MPM should be “understood, predictable and reasonable” for *market participants*, so that they know how they are permitted to compete.
- **Transparent:** Vital for avoiding Type 1 errors (so a major omission from the appraisal of options on slide 66 of the presentation on 02/12/15)

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**For competition to thrive, MPM must set out transparently what (kind of) behaviour is prohibited, so as not to discourage competitive behaviour**

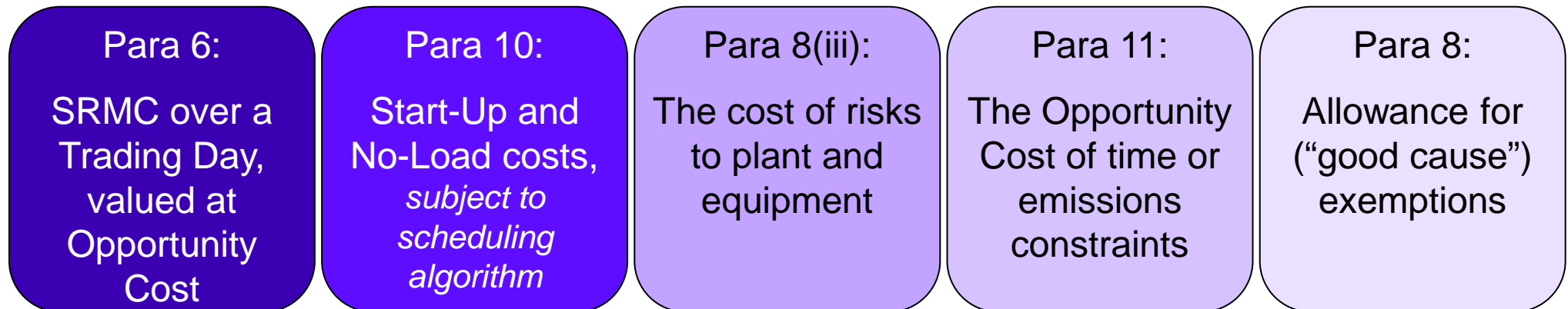
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# The Consultation Paper finds that MPM have worked well in the SEM

The SEM Committee notes the success of the current MPM (paragraph 7.3.1)

- MMU – “has worked well...especially in...enforcing BCoP”
- BCoP – “has been effectively enforced” and “likely prevented...abuses”
- Directed Contracts – “effective measure...[against]... structural market power”
- Vertical Ring-Fencing – “effective working alongside other [MPM] measures”

The BCoP is not a prescriptive formula. Its success derives from its design as a flexible set of bidding principles



**The success of the BCoP shows how any new MPM will need the same flexibility, to avoid Type 1 errors when facing a similar range of costs**

# Promoting competition is different from prescriptive regulatory pricing



The Consultation Paper's objective is to "interfere with the operation of the market to the minimum extent necessary" (para 8.3.1)

- Limiting interference means seeking to promote competition, i.e.:
  - fostering the *competitive process* without imposing the *outcome*
- However, the Consultation Paper proposes prescriptive rules that impose specific prices
  - Prescriptive rules will not allow the competitive process to develop
  - Prescriptive rules put in jeopardy long-term financing of generators' activities
  - Prescriptive rules distort incentives and discourage efficient outcomes

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**Letting competition set prices is preferable to regulating prices**

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## **Proposals:**

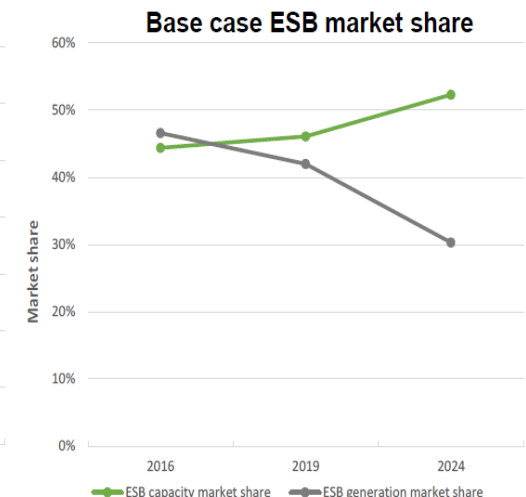
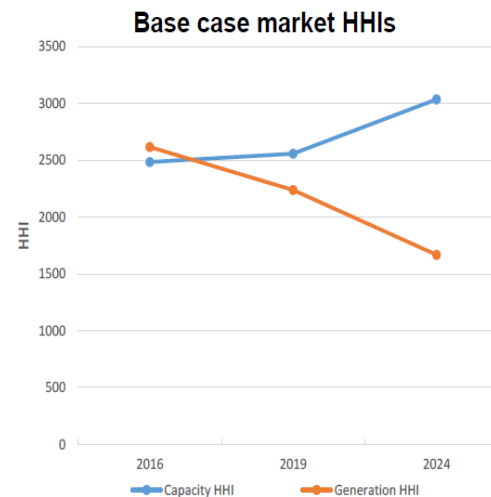
1. Identification of Candidates for MPMs
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# In order to target MPMs, the RAs need to apply some kind of filter



Chapter 6 reports market shares, HHI for *annual generation* and *capacity*, and Residual Supply Index, in 2016, 2019 and 2024

- On 02/12/15, the presenters suggested that the falling HHI for annual generation indicated the problem was diminishing.
- However, the Consultation Paper proposed “to apply the granular definition of hourly product in the DAM and IDM, and half-hourly product in the BM.” (para 3.4.2)
- “Annual generation” does not correspond to any relevant market**
- It combines *low-stress periods* (high wind and/or low demand) with *high-stress periods* (low wind & high demand)
- Trends in this HHI reflect the relative frequency of low/high-stress periods, not just the relative strength of market power.
- The structure in (half-)hourly markets is best represented by HHI for *capacity* and RSI, which are both high and rising until 2024



Source: SEM-15-099, slide 19 of 71

**HHI and RSI indicate persistent market power (for 1 or 2 players), until 2024 at least, in *peak/stress hours* and in *capacity markets*.**

# “SCP” means not only Structure but also Conduct and Performance



Structural measures provide an initial filter, but may not indicate the potential for abusive Conduct or Performance.

- For the small price-setting generators in table 6.13:
  - Many factors determine the profitability of raising offer prices
  - The next best alternative is not just “next unit in merit order” (para 6.4.25), but also alternative running regimes for other plants, which may set a lower cap on offer prices
- For forward markets – concerns over market power and liquidity arise from conduct as well as structure. See section 4 below.
- The RSI margin over demand depends on the characteristics of the market:
  - 1.1 reflects the required capacity margin in *thermal* generation markets
  - 1.2 better suits small electricity markets facing additional risks (such as *intermittent* generation)
  - See TSO paper SEM-12-105b (page 10) and HLD Consultation SEM-14-008 (para 3.3.11) explaining that the biggest in-feed is 7% of demand in GB but 20% of demand in the SEM

Useful structural measures depend on some aspects of Conduct and Performance

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**The Consultation Paper recognises the “SCP” framework (para 5.1.2) and Structural filters require further work on Conduct and Performance**

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## Preamble: The Consultation Paper adopts a highly prescriptive view of pricing

The Consultation Paper gives a strong impression of favouring prescription over flexibility:

- It proposes *only prescriptive formulae* for defining SRMC in the Balancing Market (paras 23 and 8.7.3)
- It strongly indicates a preference for SRMC pricing in DA and ID markets, using *prescriptive formulae or bidding principles* (para 8.9.3)
- It states that generator offers in general must reflect SRMC, defined as *their own cost of production excluding the exercise of market power, scarcity rents and future inframarginal rents* (para 4.2.6)

On 02/12/15, the presenters stated that omitting a principles-based option from para 8.7.3 on the BM was a “**drafting oversight**”. They referred to para 8.7.5 as evidence of the intention to allow generators to “innovate” in bidding.



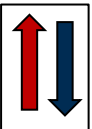
Para 4.2.6: “...In general, the RAs consider that generators should not be allowed to include their own expectation of scarcity rents or future inframarginal rents in their offers ...These issues are best addressed by appropriate market design; for example,...administered scarcity pricing...[or]...virtual bidding....”

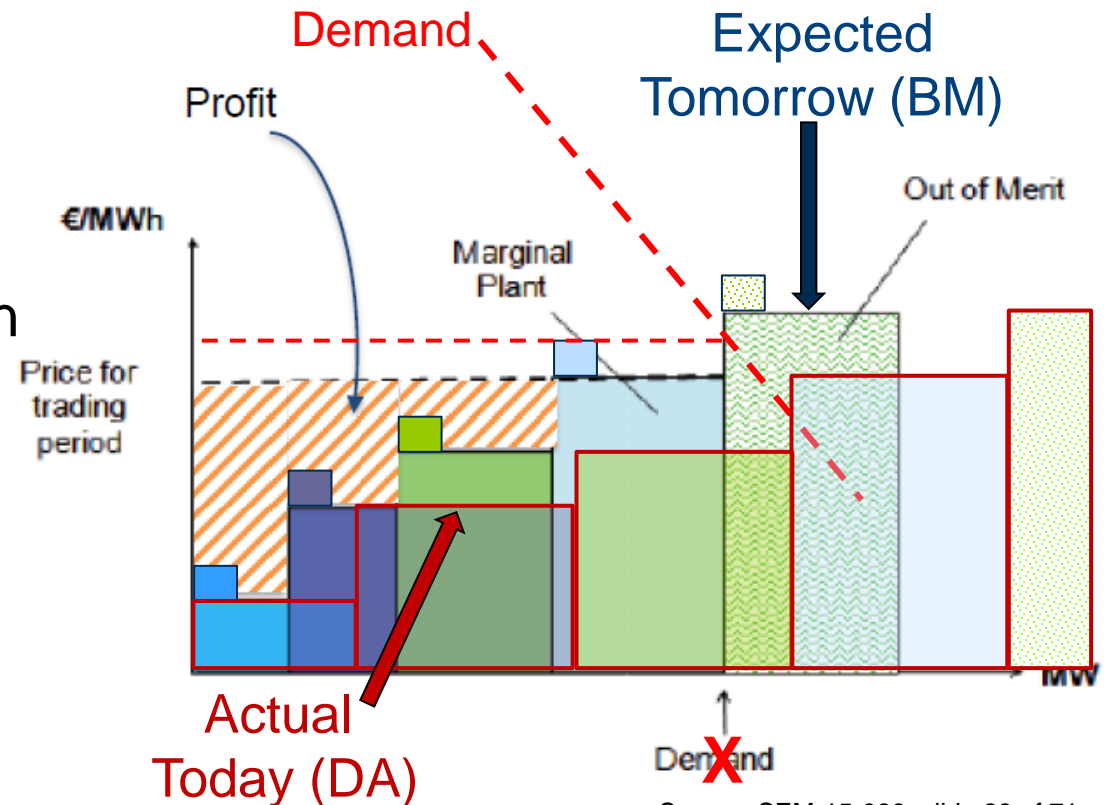
Para 8.7.5: It should be noted that for all options, the SRMC formulae still allow generators to innovate to a certain extent, in driving down costs as specific cost levels would not be prescribed. Generators could also vary prices in response to different hourly fuel prices or to different operating procedures, for example coal handling.

# Defining a competitive price is more difficult than regulating prices



Generator SRMC may not define the competitive price:

- when there are economies of scale (e.g. avoidable fixed costs); 
- when the next best alternative has a higher cost (providing an “efficiency rent”); 
- in the IDM, DAM and forward markets (which reflect *expected* BM prices); 
- and where the *pricing rule* does not reflect scarcity...



Source: SEM-15-099, slide 28 of 71

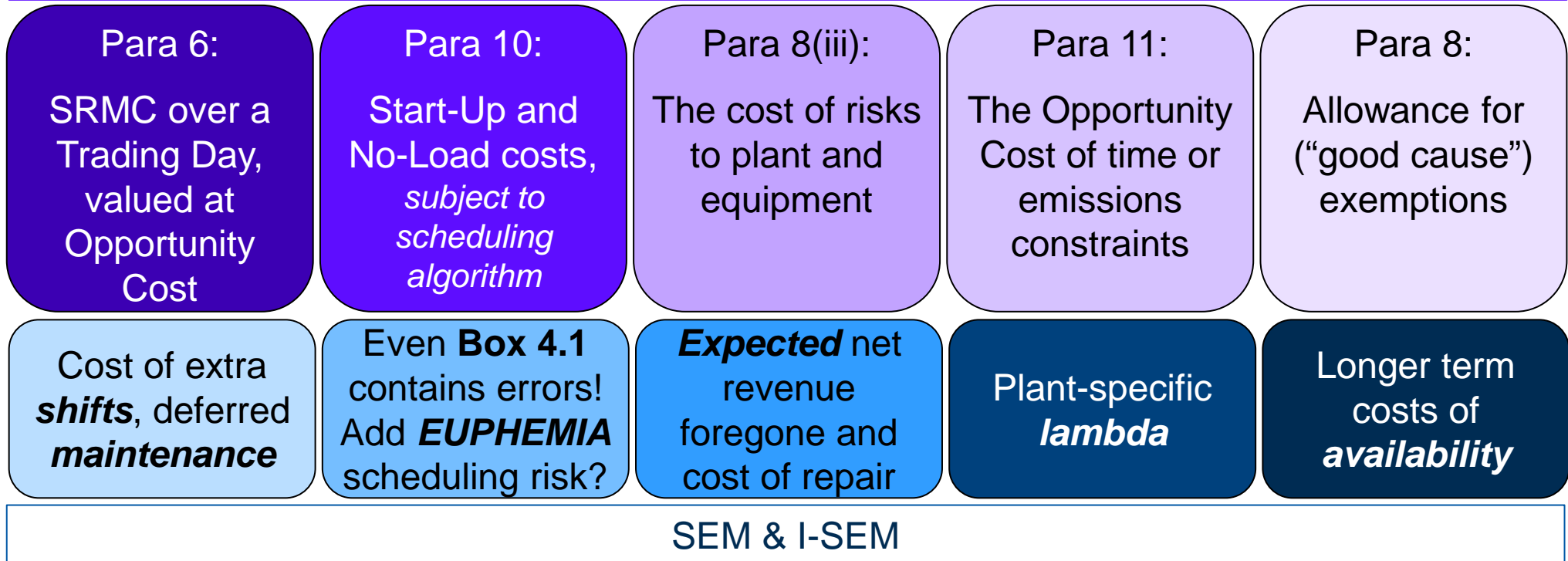
**Setting competitive prices is difficult for competition authorities.  
Regulating prices raises different questions, e.g. about cost recovery, etc**

# No prescriptive formula for SRMC will ever capture every case



Under-estimating the marginal cost of generation dampens incentives and discourages efficient production (Type 1 error)

## Bidding Code of Practice



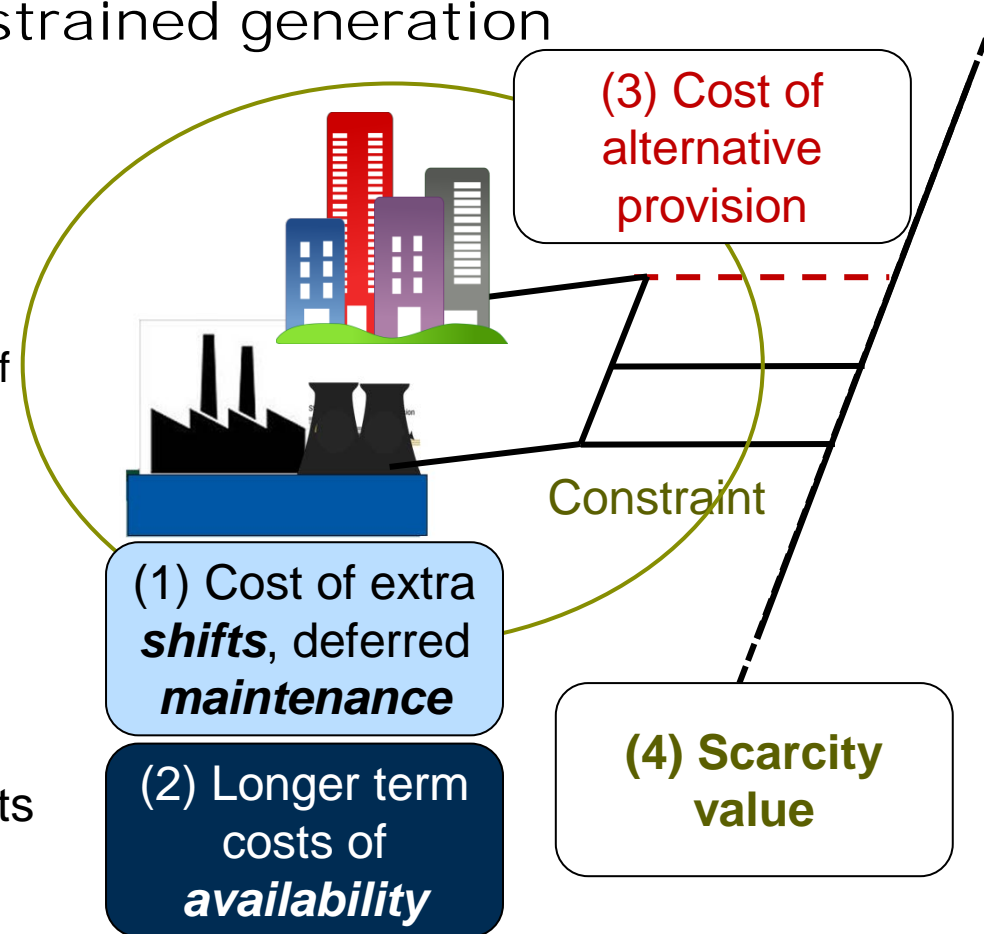
**Prescriptive rules on SRMC pricing will not promote efficient competition and will deny consumers the services they want**

# Transmission constrained generation illustrates the problems with SRMC



Tying offer prices to a narrow definition of SRMC creates several problems for constrained generation

- For single generators operating behind a transmission constraint, the competitive or efficient price in the BM is **not uniquely defined** by “SRMC”:
  - Continued supply may depend on recovery of **fixed costs** – (1) short or (2) longer term
  - The competitive price may be defined by (3) the cost of the **next best alternative**
  - Constrained generation is not subject to (4) **local scarcity pricing** (in ETA or CRM)
- Any rules must accommodate unforeseen and short-lived constraints (before contracts can be agreed and approved)



**Competitive behaviour in the BM can only be defined in principle, as in the BCoP, and not through prescriptive formulae, as in the Consultation Paper.**



# Forward markets straddle two workstreams and may fall between them



Referrals to other workstreams must be binding

- The RAs propose a “Forward Contracting Obligation” (FCO), to reduce ESB’s incentive to raise prices in the BM and other short term markets.
- The Consultation Paper recognises other concerns about ESB’s behaviour in forward markets but
  - (a) the RAs defer to REMIT and financial regulators (paras 16, 4.3.7-8); and
  - (b) the Consultation Paper refers the concerns to a “Forwards and Liquidity Workstream” (para 1.2.2)
- The concerns over liquidity are rooted in the premise that ESB possesses market power over the supply of forward contracts
  - Risk management ties contract sales to asset ownership and diversification, giving ESB market power;
  - REMIT, EMIR and MiFid only cover abusive trading, not withholding supply from third parties
- Design of the FCO (i.e. contract sales to third parties, to change ESB’s incentives) must be co-ordinated with the design of measures to enhance liquidity
  - The work of the Liquidity Workstream overlaps with the work of the MPM Workstream
  - There is a risk that neither Workstream claims the *overlap*, resulting in a *gap*

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**The stated mandate of the “Forwards and Liquidity Workstream” must cover market power (and vertical ring-fencing), as well as liquidity *per se***

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# Findings and Conclusions



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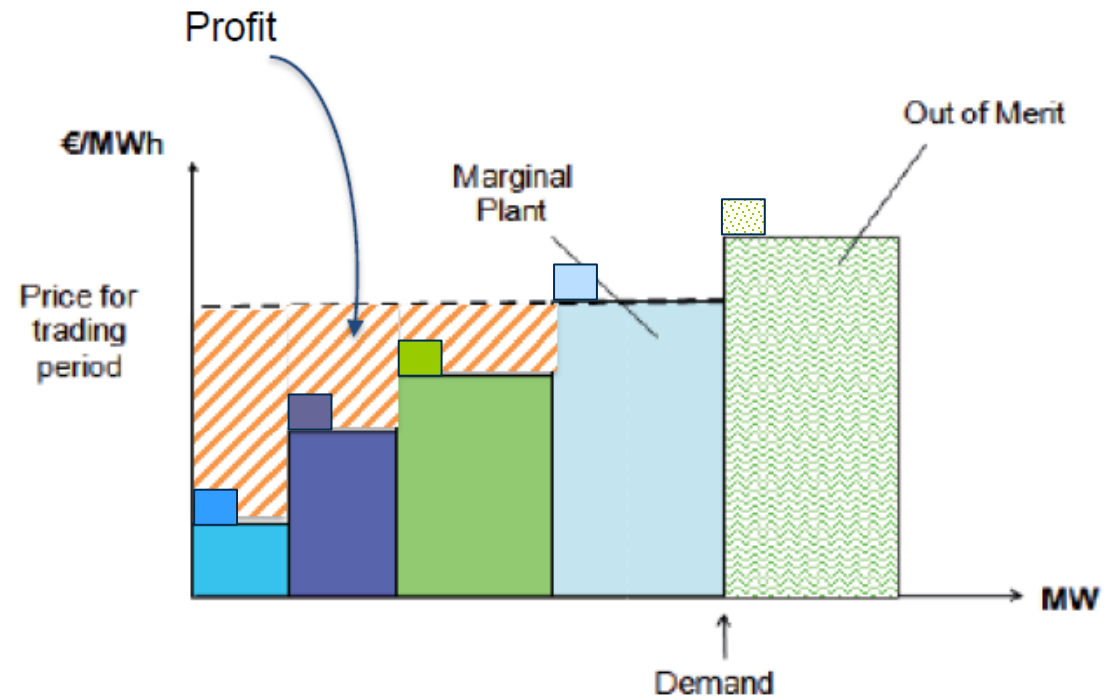
## Disaggregated slides

Detailed explanation of deviations from SRMC pricing

# Defining a competitive price is more difficult than regulating prices



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  - when there are economies of scale (e.g. avoidable fixed costs) □
  - when the next best alternative has a higher cost (providing an “efficiency rent”)
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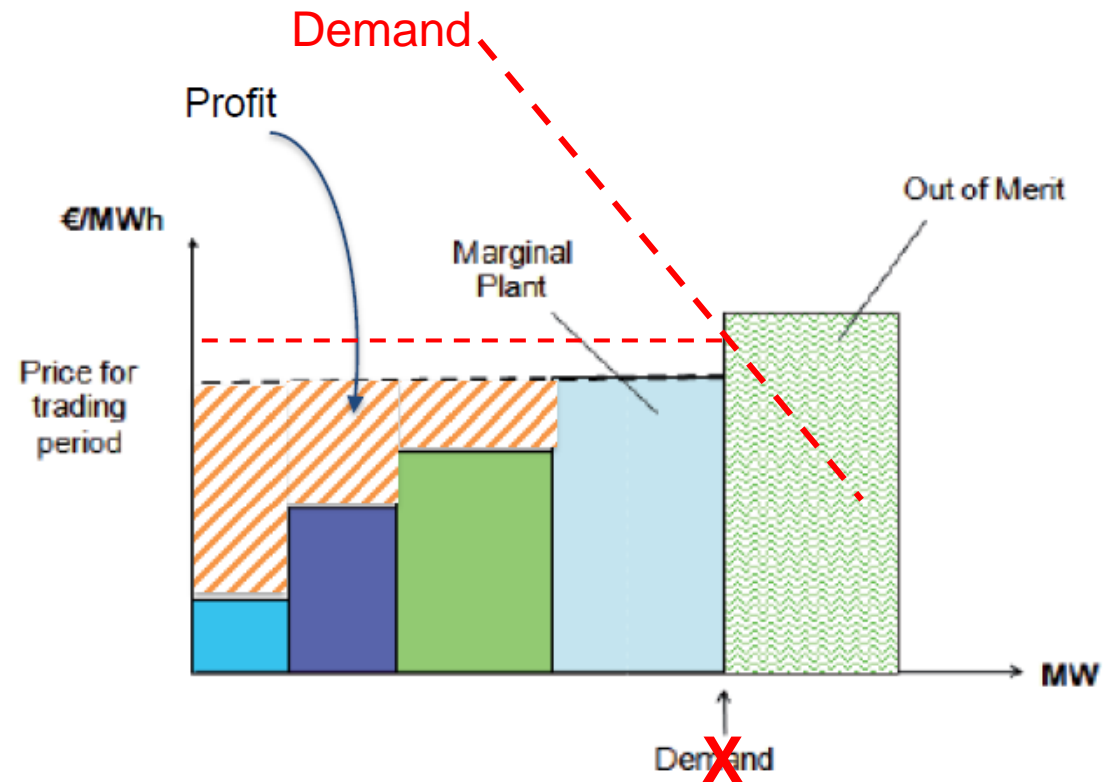


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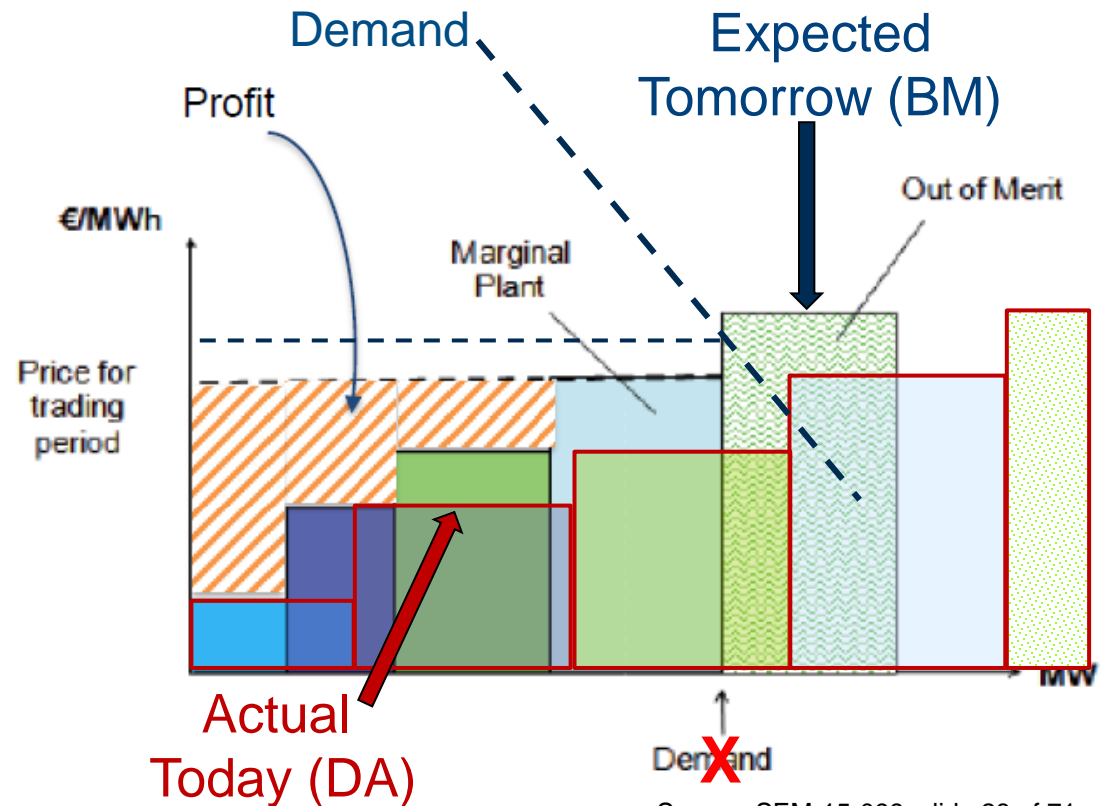
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