Energia response to SEM Committee Consultation on Measures to Promote Liquidity in the I-SEM Forward Market

Consultation Paper SEM-16-030

29 July 2016

Table of Contents

1. Introduction and Overview

This document sets out Energia's comments in response to the SEM Committee (SEMC) Consultation on Measures to Promote Liquidity in the I-SEM Forward Market, published 17 June 2016 ("the Consultation"),[1] including answers to the questions posed within the Consultation.

In support of this response, we submit a report from NERA Economic Consulting (the "NERA Report")[2], who are internationally recognised experts in electricity markets, giving their objective economic analysis of the proposals in the Consultation. NERA summarise their conclusions as follows:

- "Liquidity, however the SEM-C defines it, is a by-product of a competitive industry. Implementing a measure that increases a particular measure of liquidity does not improve competition in the SEM or I-SEM.
- The FCSO proposed under Options 2 and 3 is unlikely to lead to a sustained increase in liquidity, imposes unnecessary risks on obligated parties beyond ESB, and reinforces the anti-competitive forces present in the SEM. Refocusing the FCSO on the dominant firm and, if necessary, companies with a surplus of generation, would better target its impact on providing suppliers with access to hedging products.
- The MMO proposed under Option 4 imposes unnecessary risks on obligated companies, especially those in a net short starting position as they may be forced into unwanted sales. The additional risk may increase the cost of capital for affected companies. The MMO reinforces the competitive asymmetries present in the SEM, and provides ESB with an additional avenue to exercise market power.
- The hybrid Option 5 combines Options 3 and 4, whilst reducing the obligation of the FCSO and the MMO from their pure versions. The inclusion of the FCSO does not negate the flaws of the MMO, and vice versa. By reducing the size of each obligation, however, the SEM-C reduces the risks associated with Options 3 and 4. However, the hybrid option also limits the possible benefits present in the FCSO: the lower obligation to sell power forward may reduce access to hedging for suppliers who are short and thus hinder competition in the retail market.
- In Options 3 to 5, the SEM-C has proposed the removal of the ring-fence between ESB Generation and EI. It is not clear why this element of the proposal is necessary to the functioning of either of these obligations. Removing the ring-fence can only reinforce ESB's market dominance and hinder competition. This is consistent with previous work commissioned by the SEM-C regarding the ring-fence".

[NERA Report, section 1]

[1] Consultation Paper "Measures to Promote Liquidity in the I-SEM Forward Market", SEM-16-030, 17 June 2016.
[2] NERA (2016), "Response to the SEM Committee's Consultation on Liquidity", 29 July 2016.

We fully concur with the above conclusions and believe that there is some merit in the FCSO (as set out in Option 2), provided it is targeted more clearly on ESB (as in Option 3). However, we can see no reason for removing ESB's ring-fencing (as in Options 3 to 5). There is no merit in the proposed Market Maker Obligation (Options 4 and 5), because the MMO will be ineffective and costly, and will have adverse effects overall, on competition and on consumer interests.[3]

With respect to Option 1, Energia does not, based on currently available information, support the implementation of centralised clearing arrangements. However, we welcome the attempt to find workable solutions to the more 'mechanistic' barriers to trade that currently exist in the SEM / I-SEM forward market. We would therefore encourage the SEMC to identify alternative means to address these issues and we have suggested a number of alternative measures in our answer to question 1 below.

Specific amendments to Option 2 that we consider necessary, as discussed more fully in section 3 of the NERA Report and in response to question 4 below, are as follows:

1. We recommend that the obligation should be primarily targeted on ESB to address their dominance and to improve competition in the retail sector.
2. If the SEMC does decide to oblige generation-only companies with the FCSO, it should relax the constraint that contracts be sold in a 2/1/1 ratio of baseload, mid-merit and peaking.
3. The SEMC underestimates the volume of hedging contracts supply companies require, and thus calculates too small of an obligation.
4. The SEMC should either allocate FCSOs and DCs administratively or design auction rules that explicitly limit ESB/EI's ability to exercise its market power.

Options 3 to 5 are ill-suited to current market conditions, not least because they entail the removal of ESB's ring-fencing. The removal of the ESB ring-fencing arrangement is an ill-considered proposal, which is without justification and is not necessary to the functioning of Options 2 to 5. Removal of the ESB ring-fence would be counter to consumer interests in Ireland and Northern Ireland and counter to the objective of delivering a more competitive market. For competition to persist in the I-SEM it is therefore vital that ESB ring-fencing is not only maintained, but further strengthened. The economic, legal and procedural issues with removal of ESB ring-fencing are set out in our answers to questions 1 and 3, the NERA Report[4], and annex 1 of this response and are sufficient to rule out Options 3 to 5.

Finally, we have a concern that the compressed timeline for decision-making (ultimately resulting from over five months slippage to the publication of the consultation) risks undermining the consultation process by limiting the ability of the SEMC to fully assess and take into account consultation responses.

---

3 NERA (2016), section 4.6.
4 NERA (2016), section 2.7.

2. Consultation Questions

Below we set out our response to the questions in section 1.1 of the Consultation which should be read in conjunction with the NERA Report.

1. **Does the Consultation Paper correctly set out the nature of the problem to be solved? Is it correct that the lack of liquidity characteristic of the SEM will not be satisfactorily rectified through incentives inherent in the I-SEM design?**

Summary Response

It is evident from the NERA Report[5] that the SEMC has misdiagnosed the problem to be solved. We understand that Options 2 to 5 are intended to "promote" liquidity, whilst Option 1 is intended to remove barriers to trade. While we agree with the intention of Option 1, if not the suggested remedy, we are concerned with the stated intention behind Options 2 to 5 – i.e. to promote liquidity. As NERA explains, liquidity is a symptom of underlying market conditions, and remedies will be ineffective if they are targeted at these symptoms, without addressing the underlying problem, which is ESB dominance – i.e. the capability of ESB to exert market power.

The proposed remedies set out in the Consultation will therefore be ineffectual in addressing the underlying competition issue and are poorly targeted. Moreover, the proposed remedies will impose unnecessary costs. The currently proposed measures will oblige non-dominant generators and suppliers to adopt different trading strategies, with new risks and additional costs that will harm their ability to compete against the dominant firm, ESB. These problems are especially pertinent to companies with a negative physical position (i.e. generation less than retail sales) such as Energia. In summary, Options 2 to 5 offer little, if any, benefit for competition or consumers. In addition, these Options all have negative effects not considered in the Consultation that will make them counterproductive. With appropriate amendment, Options 2 could be made more effective. These necessary amendments are outlined in section 3 of the accompanying NERA Report and in our answer to question 4 below. We also suggest amendments to improve the effectiveness of Option 1 below.

Energia agrees that introduction of the I-SEM will not rectify the current lack of liquidity in the SEM, but that does not provide sufficient justification for the measures set out in the Consultation. This conclusion is derived from the economic analysis provided by NERA.

We recognise the description of liquidity in terms of traders' ability (1) to trade reasonable volumes without significantly moving prices, and (2) to trade "readily" in and out of contract positions.[6] However, the Consultation proposes measures that will merely inflate certain measures of liquidity, without addressing the underlying

[5] NERA (2016), chapter 2.
[6] SEM-16-030, pages 9-10.

problems that prevent a competitive market from developing. As a result, the proposed measures will have little or no impact on the fundamental competition issue existent in the forward market.

The Nature of the Problem to be Solved

As we have explained in previous submissions, competition in the retail supply market is hampered by the competitive advantage that ESB derives from preferential access to hedging instruments. We understand fully that there is likely to be an overall shortage of hedging products, because of the overall deficit of dispatchable generation that is available to back-out forward contract sales.[7] However, access to hedging products, i.e. forward contracts, is so concentrated that there is no level playing field in the retail supply business. The reasons for this are outlined below.

- First, ESB has a large and diversified portfolio of dispatchable generation (14.62 TWh) that exceeds the retail sales (12.42 TWh) of its supply business, Electric Ireland (EI). ESB therefore starts out with a balanced generation and supply portfolio at group level through vertical integration, whereas most other suppliers are short (generation less than retail sales).[8]
- Second, ESB-Generation sells some hedging contracts, but a large share is bought by EI, which denies access to other suppliers. According to the Consultation:
    - EI takes 4.38 TWh through contracts described as "internal hedges" i.e. contracts with Synergen and Coolkeeragh;[9]
    - EI also absorbs 40% (1.597 TWh out of 3.92 TWh) of the Directed Contracts (DCs) issued by ESB-Generation[10] (incidentally negating the beneficial effect of these contracts on ESB's incentive to exercise market power in spot markets); and
    - EI takes 51% (1.824 TWh out of roughly 3.6 TWh) of the non-directed forward contracts (NDCs) issued by ESB-Generation.[11]
- EI therefore absorbs c66% (7.8 TWh out of 11.9 TWh) of the forward contracts issued by ESB-Generation, despite only having 40% of the supply market, and leaving only 34% (4.1 TWh) for all other suppliers (who have 20.5 TWh of retail sales).

---

7 SEM-16-030, pages 14-15.

8 Consideration should be given to whether ESBEI is subject to the same fuel basis risk under proxy hedging as other retail suppliers, or whether proxy hedging conducted by ESBEI could act as a perfect hedge for ESB at group level via its generation and supply businesses.

9 The volume of ESB "internal hedges" – i.e. contracts that are not brought to market - is greater than the total NDC volumes sold at market by ESB-Generation.

10 SEM-16-038, *Measures to Promote Liquidity in the I-SEM Forward Market*, Open Forum, Dundalk, 6 July 2016, slide 18. SEM-16-030, Table 4.

11 SEM-16-030, Table 4. The figure of 3.6 TWh represents 4.8 TWh of NDC sales (SEM-16-030, Table 5) less about 1.2 TWh (the volume offered for sale by PPB for the 2015-2016 tariff year). There may also have been some additional NDC sales by other generators (e.g. AES who hold a long generation position), which would further increase the percentage of ESB contract sales purchased by ESBEI.

We fully appreciate that the supply market is bound to be short overall of electricity contracts for hedging purposes and that suppliers must bear some exposure to market prices or use fuel proxies. We also accept that ESB is entitled to hedge some of its own retail sales. However, for a combination of reasons relating to ESB's dominant position, its peculiar status as a state-owned company[12], and being vertically integrated at group level, ESB-Generation has little incentive to sell forward contracts to suppliers other than EI. Furthermore EI can pay a higher price than other retail suppliers for forward contracts sold by ESB-generation because the transfer price between EI and ESB does not affect group-level profitability. In the I-SEM, EI will therefore continue to be able to secure a disproportionately large share of the hedging products available in the market. ESB's actions therefore (1) give a strong competitive advantage to an already dominant firm, (2) give other suppliers no opportunity to acquire a similar volume of hedges, and (3) make it impossible for other suppliers to compete with ESBEI on a level playing field.

We have explained these problems in previous submissions and correspondence[13], but neither the Market Power Mitigation (MPM) Workstream nor the F&L Consultation takes them into account. Furthermore, the NERA Report clearly identifies a misconception that lies behind the (tentative) conclusion reached in the MPM Decision Paper (SEM-16-024) that market power is not – indeed, cannot be – a problem for forward markets. This conclusion is predicated upon the assumption that there are no material barriers to entry. The NERA Report explains how the costs and risks of engaging in speculative trades (i.e. sales that widen negative positions) within the I-SEM forward market act as a barrier to entry.[14] Therefore, the absence of entry to the SEM forward market does not indicate that the market is competitive.[15] The MPM Decision Paper's rejection of market power in forward markets is therefore based on an "over simplification" – a possibility recognised in the MPM Decision Paper itself.[16]

ESB's Ring-Fencing

The treatment of ESB's ring-fencing in the Consultation provides further evidence that the problem in forward markets has been misdiagnosed. We find it remarkable that the SEMC should suggest the removal of ESB's ring-fencing at the point of embarking on new and unproven market arrangements, when there will be less structural market power mitigation measures in place, and potentially less transparency[17], than in the current SEM (despite the SEMC having identified in the MPM Decision that there is an ongoing concern regarding structural market power in

---

12 Because of ESB's position as a large, state-owned company, it is unlikely to operate with entirely commercial objectives.

13 Most recently for example please see Energia correspondence to RA Directors on 9 May 2016; Energia presentation to RAs on 21 April 2016 and Energia response to SEM-15-094 on 18 January 2016.

14 NERA (2016), section 2.3.

15 NERA (2016), section 2.5.

16 SEM Committee, *Integrated Single Electricity Market (I-SEM) –I-SEM Market Power Mitigation – Decision Paper* (SEM-16-024), page 9.

17 See SEM-16-024, paragraph 8.12.22 which states "that there is likely to be less transparency to the wider market in I-SEM. For example, all bids and offers in the current SEM are published within a number of days to the wider market. It is likely that only anonymised aggregate bid curves for the ex-ante markets in I-SEM…" (p62).

the I-SEM[18]), particularly since the Consultation offers no evidence regarding the benefits of removing ESB ring-fencing. Furthermore, the Consultation links the removal of ring-fencing to some expansion of the obligations on ESB, but provides no explanation as to why such a move is actually necessary.

The reasons for imposing the ring-fencing were clearly set out in an independent report written by CEPA in 2010 which concluded that ring-fencing is important for maintaining liquidity and protecting consumers' interests.[19] The SEMC accepted CEPA's recommendations in 2012 and noted that it would:

> "[C]onsider any proposals for ESB vertical integration in the context of a material change to market power in the SEM. An example of a material change would be a significant reduction in ESB's generation plant portfolio".[20]

As NERA point out, "[a]ny proposal to remove the ring-fence would have to demonstrate either that changes in market conditions since their earlier work in 2010-12 had overturned the original case for ring-fencing, or that removing the ring-fence was necessary to achieve certain benefits that were not considered in 2010-12."[21] However, the Consultation Paper does not demonstrate that either of those conditions has been met. NERA conclude that "[r]emoving the ring-fence can only reinforce ESB's dominance and hinder competition"[22]. It is therefore clear that the removal of vertical ring-fencing from ESB is entirely inappropriate and unjustified, and is likely to be highly detrimental to Energia and other operators in the I-SEM.

There are good reasons to build interventions in the forward market around the special position of ESB as a dominant firm, but we see no reason why removing the ring-fencing would help in this regard. Indeed, the very existence of the ring-fencing confirms ESB's special status and justifies special treatment to overcome its dominant position and facilitate retail competition. We therefore conclude that removing the ring-fencing is neither beneficial nor necessary for implementing the SEMC's proposals.

We would further note that the SEMC has provided no substantive and independently verified evidence as to why it should even be considered at the present time. While the SEM Committee postponed "*any consideration of the merits or otherwise of amending the current framework with regards to vertical integration/ring-fencing"* [23] to the present consultation, there is in fact no consideration whatsoever of the merits or otherwise of this issue. Both Options 3 and 4 (and 5, which is a combination of 3 and 4) include the removal of ring-fencing obligations but do not offer any rationale for it. Option 3 is in fact Option 2 with ring-

---

18 See for example paragraph 6.3.8 of SEM-16-024 which states that "[t]he SEM Committee is of the view that the modelling results indicate that the market concentration of ESB remains a concern in the I-SEM DA and ID markets".

19 CEPA (2010), *Market Power and Liquidity in SEM - A report for the CER and the Utility Regulator*, 15 December 2010

20 SEM Committee (1 February 2012), *SEM Market Power & Liquidity – A SEM Committee Decision Paper – SEM-12-002*, p4.

21 NERA (2016), Executive Summary, page iv.

22 Ibid, footnote 18.

23 SEM-16-024, p7.

fencing removed although no explanation is provided as to how liquidity will improve as a result (in fact, if anything, it is suggested that it would make matters worse, therefore requiring an increase in the volume of FCSO required and the SEM Committee notes that "*the removal of ring-fencing would make it difficult to disassociate market power in the demand or generation side of ESB"*). As regards Option 4, the SEM Committee advances that "*vertical integration, even if not absolutely necessary, would strengthen the capacity of the market maker to offer volumes as the key requirement is financial strength of the company to take on a market maker risk"* (emphasis added). This is sufficient for the SEM Committee to take the view that "*in order to implement this option, ESB's ring-fencing arrangements should be removed".* If it is not necessary, however, then there should be consideration of the extent of whatever additional benefit from a liquidity perspective removing ring-fencing obligation would bring, before it can be included as part of an option for promoting liquidity in the forward market.

In the absence of any reason why vertical ring-fencing in respect of ESB should be removed, it is impossible to assess its merits and, assuming there are benefits (which we do not believe however there are), whether it is a necessary and proportionate measure, everything else considered. We believe that having regard to the reasons why ring-fencing obligations were imposed and the current market position of ESB, this is not the case and absent detailed analysis, the status quo should prevail. If the view continues to be that removing ring-fencing obligations on ESB ought to be considered, then detailed analysis and explanations are required in order to understand, and assess, why the current framework should be amended. However, none has been offered in the Consultation.

In conclusion therefore the removal of the ESB ring-fencing arrangement is an ill-considered proposal, which is without justification. The vertical re-integration of ESB would present a real risk to consumer interests and should be rigorously assessed by the RAs for its impact on competition. Removal of the ESB ring-fence would be counter to consumer interests in Ireland and Northern Ireland and counter to the objective of delivering a more competitive market. For competition to persist in the I-SEM it is therefore vital that ESB ring-fencing is not only maintained, but further strengthened.

Please see annex 1 for an expanded discussion of the concerns articulated above regarding the potential vertical reintegration of ESB.

Moving Towards a Solution for I-SEM Forward Markets

Any discussion of regulatory interventions in forward markets should begin from the following observations:

1) that there is a perennial shortage of hedging opportunities for suppliers;
2) that EI has access to a disproportionately large share of the available hedging products offered by ESB's generation portfolio (both by virtue of the benefits

that accrue as a result of vertical integration at Group level[24] and by contracts between Synergen and Coolkeeragh with ESBIE, which is now part of EI); and

3) that suppliers cannot compete on a level playing field until access to the limited supply of hedging products is more evenly distributed.

The Consultation already acknowledges the shortage of hedging opportunities. The figures given above, which are taken from the Consultation, demonstrate that ESBEI secures a disproportionately large share of the hedging products, while the continuing dominance of ESB means this will continue into I-SEM unless the issue is properly addressed. The work of the F&L Workstream therefore needs to be directed towards creating a more even distribution of hedging products across suppliers to level the playing field to facilitate retail competition.

Our comments below take this analysis fully into account and offer amendments intended to ensure that versions of Options 1 and 2 can contribute towards a more competitive forward market, better able to serve the interests of consumers.

2. Does the scope of the Consultation Paper set out the full range of potential liquidity promotion measures that should be considered for implementation? If other regulatory interventions are considered appropriate please set out the nature, rationale and parameters of such intervention?

Option 1

Discussion of Option 1 in the consultation paper identifies that there are a number of trading barriers existent in the current forward market – e.g. the lack of a standard form of contract and onerous credit requirements. As set out in our answer to question 3 below, we have significant concerns that while central clearing may address some of these issues, it could increase barriers to trade in other areas, such as working capital requirements. Based on the current information available we therefore do not believe introduction of central clearing will produce a net benefit, and we are concerned it could make the barriers to trading in the I-SEM forward market worse.

There are a number of useful aspects of exchange based trading however that can be delivered without implementation of central clearing and we recommend that these are considered as an alternative. They include:

1. Use of a transparent trading platform (such as the current Tullet Prebon platform). This would provide transparency in relation to the execution of trades. Use of a trading platform does not need to be linked to centralised clearing arrangements.

[24] As explained earlier, EI can pay a higher price than other retail suppliers for forward contracts sold by ESB-generation because the transfer price between EI and ESB does not affect group-level profitability. In the I-SEM, EI will therefore continue to be able to secure a disproportionately large share of the hedging products available in the market.

2. A regulatory led process to facilitate development of a standard form of contract for the I-SEM forward market – e.g. adopt an approach similar to ISDA were a standard agreement is developed that could be used on a universal basis as a template for contract discussions. Any bespoke conditions, such as credit requirements, could then be implemented via annexes.[25] ***We would strongly recommend that this process is initiated as soon as possible to facilitate the ability of counterparties to trade forward contracts for delivery dates beyond the go live date for I-SEM.***

3. A review carried out by the regulator on the credit terms prevalent in the current SEM forward market, to ensure they are consistent with credit terms in competitive markets.

4. A licence condition to ensure that the largest generators deal fairly with *all suppliers* that mandates a negotiating procedure, transparent credit terms and obligations on prices offered. For instance, something akin to the Supplier Market Access (SMA) leg of the Secure and Promote licence condition in GB which, unlike the MMO leg, was found by the CMA to have had a positive effects on competition[26]:

   - Imposing strict time limits and on generators for offering terms (or fully explaining a refusal to trade) and a requirement to continue negotiating except by mutual agreement; [27]

   - Requiring an "established process for assessing credit worthiness" and discussion of a range of alternative credit options with the supplier. Generators must set out basis of their credit decision in a transparent, Ofgem-mandated form;[28] and

   - Requiring that the price offered must be as good as the best price available to the generator in the market. Generators must justify and itemise any additional costs from trading in small quantities or wholesale market trading fees.[29]

5. Robust market monitoring of the I-SEM forward market, including regular assessment of, and reporting on, 'health' metrics, such as volume of trades, price of transacted products, bid / ask spreads, etc. This would greatly add transparency.

---

[25] Development of a standard form of contract for the I-SEM forward market is essential given the unnecessary further complexities introduced into the contracting process due to the I-SEM capacity mechanism. Reliability options are a form of forward energy contract and occupy the same 'space' as normal forward contracts. Therefore they will add a further, and unhelpful, layer of complexity to bilateral contract negotiations.

[26] See NERA Report, section 4.3.

[27] Special Condition AA: Liquidity in the Wholesale Market, Schedule A, paras 2-7.

[28] Special Condition AA: Liquidity in the Wholesale Market, Schedule A, paras 8-10.

[29] Special Condition AA: Liquidity in the Wholesale Market, Schedule A, paras 16.

Options 2 to 5

As set out in our answer to question 1 above there are significant problems with Options 2 to 5 as set out in the Consultation because they are based on a misdiagnosis of the issue in the SEM / I-SEM forward market. The precise nature of the problems with each option is discussed in detail in the NERA Report and in our answer to question 3. Here, we summarise our response to the Options presented in the Consultation.

First, Options 3 to 5 are ill-suited to current market conditions, not least because they entail the removal of ESB's ring-fencing. The economic, legal and procedural issues with removal of ESB ring-fencing are set out in our answers to questions 1 and 3, the NERA Report[30], and annex 1 of this response and are sufficient to rule out Options 3 to 5.

We also find Options 4 and 5 to be poorly designed, because a Market Maker Obligation (MMO) is ill-suited to remedying the underlying problems in the SEM / I-SEM forward market. As the NERA Report explains, there is little hope of creating liquidity in a market with limited competition and explicit measures for mitigating market power, due to distrust of the market ("information asymmetry") among potential traders.[31] Indeed, in its recent enquiry into energy markets in Great Britain, the CMA found that similar measures did not increase liquidity even in more competitive conditions.[32] The MMO is therefore unlikely to achieve the benefits suggested in the Consultation.

Energy trading and the MMO

The SEMC has misunderstood the costs of forcing energy companies in the I-SEM to carry out "speculative" trades (i.e. sales that increase net deficits or purchases that increase net surpluses) against their will.[33] Energia has managerial procedures in place to prevent involvement in such speculative trades. These procedures ensure that our trading complies with commercial and financial constraints (e.g. terms and conditions of financing and also regulatory constraints including EU directives and regulations on financial markets). We believe that other companies in the I-SEM are organised in a similar fashion. Forcing Energia and others to embark on a different trading strategy at this point will require: a major reorganisation of our business model; a new approach to regulatory compliance; and potentially amendments to the conditions of Viridian's financing arrangements. These changes will greatly increase our costs of operating within the I-SEM and hinder the ability of Energia to compete.

The Consultation presents a false picture of the ease with which energy companies and financial institutions can enter into speculative trading of forward contracts. It

30 NERA (2016), section 2.7.
31 NERA (2016), section 2.2.
32 NERA (2016), section 2.5.1, quoting Competition and Markets Authority (2016), *Energy Market Investigation: Final Report*, 24 June 2016, Appendix 7.1, paras 89-93.
33 NERA (2016), section 2.3.

does not take account of the associated costs and risks, the imposition of which would favour large, dominant firms over smaller independent competitors. The MMO is therefore not a costless option. On the other hand, it offers few potential benefits, because it addresses a symptom, rather than the fundamental problem in SEM / I-SEM forward markets. As the NERA Report confirms, the MMO will therefore have adverse effects overall, on competition and on consumer interests.[34] These impacts should be carefully considered and taken into account.

Tailoring the FCSO to Actual Market Conditions and Underlying Problems

We would however advocate an amended version of Option 2, the Forward Contract Sell Obligation (FCSO), provided that it was adapted to address the fundamental issue of ESB dominance. Our reasons link back to the diagnosis of the problem summarised in our answer to Question 1.[35] The FCSO can help to provide a level playing field in the retail supply market, by giving each supplier an opportunity to acquire the same level of hedging. (This policy would amount to a one-time *transfer of title*, rather than contributing to frequent trading or any other measure of *liquidity*.) That policy requires the FCSO to focus on ESB and only extend to other companies if there is good reason to do so. As the NERA Report points out, imposing the FCSO on companies with a negative physical position seems unnecessary and counter-productive.[36]

As for the obligation itself, we would welcome a reconsideration of the calculations. We recognise that there is a perennial shortage of hedging products in electricity forward markets, but the proposed FCSO seems to entrench the existing level of shortage by adopting the current reliance on fuel proxies. The SEMC should instead be trying to expand ESB's sales to other suppliers (excluding EI), thereby reducing their reliance on fuel proxies.

We also note the concern raised by NERA over the proposal that every affected generator should sell the same portfolio of baseload/mid-merit/peak contracts, regardless of their forecast generation.[37]

The rule that each generator must sell the same portfolio of contracts through the FCSO will adversely affect companies that have a limited generation portfolio, e.g. no baseload plant or no peaking plant, and will give a competitive advantage to companies that own a diversified portfolio, such as ESB. This aspect of the proposal therefore favours the dominant firm over its main competitors.

At a minimum the SEMC should construct an obligation suited to the output pattern of each company. However, even if they were to do so, the inherent uncertainty in any forecast would tend to favour companies with a diversified portfolio, such as ESB. As NERA notes, the forecast outputs for non-diversified generators will be

---

34 NERA (2016), section 4.6.
35 See also NERA (2016), chapter 3.
36 NERA (2016), section 3.2.
37 NERA (2016), section 3.2.4.

more volatile than for diversified generators such as ESB.[38] Accordingly, the FCSO design places more commercial risk on non-diversified generators, whose generation is less likely to match their obligation. This additional commercial risk will distort competition in favour of generators with a large diversified portfolio and a more predictable volume of generation, thereby increasing costs for consumers; [39] an outcome that could be avoided by only placing an FCSO obligation on large, diversified market participants.

Proceeding with a fixed and common contract portfolio and imposing the same volume obligation regardless of forecast generation may therefore be discriminatory, since it applies the same treatment to different companies without objective justification.

Conclusion

We believe that there is some merit in the FCSO (as set out in Option 2), provided it is targeted more clearly on ESB (as in Option 3). However, we can see no reason for removing ESB's ring-fencing (as in Options 3 to 5). There is no merit in the proposed Market Maker Obligation (Options 4 and 5), because the MMO will be ineffective and costly, and will have adverse effects overall, on competition and on consumer interests.[40]

3. Respondents are asked to provide their views on the rationale, parameters and potential effectiveness of each of the regulatory interventions described and explained in the Consultation Paper.

As set out in our answer to question 2 above, Energia welcomes the acknowledgement in the discussion of Option 1 in the Consultation that barriers to trading exist in the I-SEM forward market. We also support the SEMC endeavours to investigate measures to minimise these barriers. However, based upon the information that is currently available on how centralised clearing may operate in the I-SEM we are concerned that it will not produce an overall reduction in barriers to trade, and therefore a net benefit for the market. We therefore recommend that prior to the any decision by the SEMC to introduce centralised clearing arrangements a full CBA is carried out. Our main concerns are outlined below:[41]

1. Centralised clearing could significantly increase working capital requirements. Slide 39 presented at the Forward and Liquidity workshop on 6th July 2016 stated that a Central Clearing Party (CCP) would be unlikely to accept Bank Guarantees (i.e. Letters of Credit), requiring counterparties to post cash for forward exposures. Assuming daily margining counterparties will have to post

---

38 NERA (2016), section 3.2.5.

39 For example, the flexible thermal plant that the RAs need to encourage to hit their 75SNSP target may find it particularly difficult to forecast their generation, and therefore this rule may increase their costs and therefore the system integration costs of non-dispatchable generation.

40 NERA (2016), section 4.6.

41 These concerns are based upon the limited information that has been made available via the Consultation and the Forward and Liquidity public workshop held on 6 July 2016. We reserve our right to amend our position on central clearing if the assumptions behind the concerns raised in the answer to this question turn out to be incorrect.

excess cash margin at all times to ensure daily margining requirements are met, due to what are likely to be extremely short timeframes for posting additional cash to meet daily margin calls. Furthermore, in an illiquid market, where counterparties cannot close and re-open positions, such arrangements will result in counterparties having to post significant cash amounts to meet margin calls following adverse market price movements. Without the ability to post Letters of Credit as collateral centralised clearing arrangements are therefore likely to result in a significant increase in working capital requirements that will pose a significant barrier to trade.

2. There are unlikely to be obligations imposed on Clearing Member(s) (CMs) to offer services to participants and rather provision of services will be determined by means of a formal assessment of their credit worthiness. Therefore the requirement to engage a Clearing Member in order to transact through a CCP may raise a significant barrier to entry for participants, particularly small and / or less credit worthy participants. Such participants could be excluded from trading in products bought or sold on a centrally cleared basis. Additional costs will also be incurred through clearing fees, which could differ substantially between CMs.

3. Under centralised clearing arrangements participants are unable to diversify their counterparty risk unless there are several CMs. For example, a CM is likely to limit the maximum financial exposure they are willing to except to a participant, and therefore limit the volume of trades that a participant can complete, or they could decide to exit the market. To diversify these risks participants will have to put in place arrangements with several CMs. This however increases costs for participants (reducing the potential benefits of introducing central clearing arrangements) and reduces trade volumes for participating CMs. Given the small size of the I-SEM contract market the latter may make the business case for potential CMs unfavourable.

4. It is unclear what the initial credit requirement would be under centralised clearing arrangements and whether any reduction in the current over-collateralisation of the forward contracts in the SEM forward market would be offset by increased working capital requirements.

5. A potential benefit of centralised trading arrangements could be the ability to net credit requirements with other markets such as the Day-Ahead and Intra-Day markets. For netting to occur, however, the CCP would have to be ECC, which is not guaranteed. Furthermore, the benefits of any potential netting would be more than offset if there is a requirement to post cash for forward market exposures, and the fact that collateral cannot be netted between commodities and derivative markets.[42]

[42] See slide 39 presented at the public Forward and Liquidity Workshop on 6 July 2016.

6. We have significant concerns regarding the timelines set out for implementing centralised clearing arrangements. It would seem unrealistic to assume that a centrally cleared forward market could be created by May 2017 given the requirement for all relevant participants to negotiate agreements with a CCP and CM. Such negotiations can sometimes take anything up to c12 months. However, these negotiations are unlikely to commence until, at the earliest, Q1 17 based on slide 42 as presented at the public Forwards and Liquidity workshop on 6 July 2016.

Based on the information currently available, Energia therefore does not support the implementation of centralised clearing arrangements. However, we welcome the attempt to find workable solutions to the more 'mechanistic' barriers to trade that currently exist in the SEM / I-SEM forward market. We would therefore encourage the SEMC to identify alternative means to address these issues and we have suggested a number of alternative measures in our answer to question 1 above.

Option 2

An FCSO could be effective if it were directed at ESB's market power. As set out in the Consultation, however, the FCSO under Option 2 places unnecessary costs and risks on non-dominant generating companies through:

- the obligation to sell contracts at ratios that may not match their generation profiles, meaning that generation companies with only mid-merit or peaking capacity will be short on the delivery of baseload. Depending on the obligation level and their precise position in the merit order, baseload generators may be able to meet obligations to sell mid-merit and peaking contracts from their own generation. However, doing so could leave them with stranded output which is expensive or not feasible to hedge and which would increase their risks and costs;[43]
- the obligation on smaller vertically-integrated companies to make sales contrary to their commercial interest. This is particularly true for companies in a net short position that will then have to purchase even more contracts to close out their positions. Straying into even shorter positions could also increase their operating and financing costs;[44] and
- the obligation on generation-only companies to sell at all. Having no supply arm, these companies should already be incentivised to sell electricity forward by necessity to hedge profit margins, assuming such behaviours occur in I-SEM the obligation would only impose unnecessary administrative costs.[45]

These costs and risks will tend to encourage premature exit or discourage entry, and their implementation may be discriminatory. Therefore, we believe that option 2 as set out in the Consultation will hinder competition rather than improve it.

---

[43] NERA (2016), section 3.1.4.
[44] NERA (2016), section 3.2.2.
[45] NERA (2016), section 3.2.4.

Additionally, the volume obligation on ESB is too small, because the SEM Committee deducts an excessive amount for suppliers' use of fuel proxies and interconnectors to hedge their risks.[46] In fact, Option 2 as proposed perversely does not oblige the dominant firm to sell a larger volume of contracts than it would otherwise.

Option 2 as presented in the Consultation is therefore not a suitable option.

The FCSO is discussed in detail in Chapter 3 of the NERA report, and Option 2 in particular is discussed in Section 3.2.

Option 3

Option 3 is similar to Option 2, except that it removes the ring-fence on ESB Generation and Electric Ireland, and places additional obligations and restrictions on ESB/EI. We welcome the additional obligations and restrictions on ESB/EI, but we do not see why the removal of the ring-fence must accompany the restrictions, unless the SEM Committee views these as a concession to ESB for the additional restrictions. As we discuss elsewhere in this response and later in the response to this question, the removal of the ring-fence is unnecessary and, in fact, hinders the goals of the Consultation.

Option 3 is therefore not a suitable option.

The FCSO is discussed in detail in Chapter 3 of the NERA Report, and Option 3 in particular is discussed in Section 3.3.

Option 4

The MMO places unnecessary risks on obligated companies, especially on those which have a net short starting position, (e.g. Energia). This is exacerbated by the fact that our credited generation in the Consultation includes non-dispatchable generation, which we cannot rely upon to internally hedge our supply arm[47]. The MMO therefore would place Energia at risk of being forced into unwanted sales, putting us even further into deficit and potentially requiring us to purchase back contracts at higher prices to close out our position.[48]

The additional, and unnecessary, risk of being forced further into deficit and of the resulting distress purchases may increase the cost of capital for affected companies. It will increase operating costs and there may be additional costs associated with regulatory compliance (such as European financial regulations).[49] Furthermore, ESB's large share of the market making obligation may give it another opportunity to exercise its market power if another company needs to buy to close out its position.

---

46 NERA (2016), section 3.2.3.

47 It is fundamentally incorrect to include non-dispatchable generation in these calculations and therefore revised analysis would have to be presented were the SEMC to proceed with this any form of this measure.

48 NERA (2016), section 4.4.1.

49 NERA (2016), section 4.4.3

Therefore, Option 4 reinforces, rather than mitigates ESB's position and further hinders competition.[50]

It is not clear why the removal of the ring-fence is necessary for the MMO. If it is necessary to be vertically integrated to act as a MM then Energia should be excluded based upon our large net-short position. If instead a company's financial strength supports its ability to be a market maker, then the SEM Committee should allocate the MMO according to the financial strength of the parent group, regardless of company structure – i.e. they should include ESB-Generation and ESBEI as two separate MMs.[51]

Option 4 is therefore not a suitable option.

Option 4 is discussed in detail in Chapter 4 of the NERA Report.

Option 5

Option 5 comprises a hybrid of the FCSO and the MMO, with the obligations on each half as large as in the pure policy options. The underlying flaws of each component remain in the hybrid version because the inclusion of the FCSO does not naturally offset the flaws of the MMO, and vice versa. (Although the hybrid option may impose less risk under each obligation due to the lower volume of trades and/or bids and offers required, the cumulative risks stemming from both obligations together may not be substantively lower. To the extent that any costs of either obligation are fixed, such as the costs of hiring additional staff to operate an MMO, imposing both obligations will result in additional costs to be recovered from consumers.). Moreover, the hybrid option also limits the possible benefits present in the FCSO: the lower obligation to sell power forward placed upon ESB may reduce access to hedging for suppliers who are short and thus hinder competition in the retail market.

Option 5 is therefore not a suitable option.

Option 5 is discussed in detail in Chapter 5 of the NERA report.

General Comment on Ring-fencing

In Options 3, 4 and 5, the SEMC has proposed variants that remove the ring-fence between ESB-Generation and Electric Ireland. It is not clear why the SEMC believes this element of the proposal is necessary to the functioning of either of these obligations. It is not. Removing the ring-fence can only reinforce ESB's market dominance and hinder competition.

As described in answer to question 1 above, the RAs and their consultants have previously concluded that ring-fencing is important for maintaining liquidity and protecting consumers' interests.[52] Any proposal to remove the ring-fence would

[50] NERA (2016), section 4.4.2
[51] NERA (2016), section 4.5
[52] CEPA (2010), *Market Power and Liquidity in SEM - A report for the CER and the Utility Regulator*, 15 December 2010

have to demonstrate either that changes in market conditions since their earlier work in 2010-12 had invalidated the original case for ring-fencing, or that removing the ring-fence was necessary to achieve certain benefits that were not considered in 2010-12. The Consultation provides no such justification for removing the ring-fencing of ESB-Generation and Electricity Ireland.[53]

In conclusion therefore the removal of the ESB ring-fencing arrangement is an ill-considered proposal, which is without justification. The vertical re-integration of ESB would present a real risk to consumer interests and should be rigorously assessed by the RAs for its impact on competition. Removal of the ESB ring-fence would be counter to consumer interests in Ireland and Northern Ireland and counter to the objective of delivering a more competitive market. For competition to persist in the I-SEM it is therefore vital that ESB ring-fencing is not only maintained, but further strengthened.

Ring-fencing is discussed generally in Section 2.7 of the NERA Report. NERA further discusses it in Section 3.2.2 (with respect to the FCSO) and Section 4.5 (with respect to the MMO). Also see annex 1 of this response along with our answer to question 1 for an expanded discussion of our concerns regarding the potential vertical reintegration of ESB.

4. What are the important issues to be considered in each of the options? In what way might the options be made more effective? Please set out your views on the rationale for, and value of the parameters employed to determine, the quantity of the obligation in each option?

Important issues to be considered

We have summarised the nature of the problem the SEM Committee should solve in our response to question 1. In particular, ESB has a competitive advantage that derives from:

- Its size, which may allow it to influence prices in the spot market or (potentially) the forward market; and

- Its large and diversified portfolio of dispatchable generation (14.62 TWh) that exceeds the retail sales (12.42 TWh) of EI. ESB therefore starts out with a balanced generation and supply portfolio at group level through vertical integration, whereas most other suppliers are short (generation less than retail sales).[54]

ESB therefore has little incentive to offer forward contracts to sell its generation to suppliers other than EI, which leaves other suppliers exposed to price risk.

---

[53] NERA (2016), section 2.7

[54] Consideration should be given to whether ESBEI is subject to the same fuel basis risk under proxy hedging as other retail suppliers, or whether proxy hedging conducted by ESBEI could act as a perfect hedge for ESB at group level via its generation and supply businesses.

If instead of focusing on interventions to improve some arbitrary measure of liquidity, the SEM Committee focuses on improving other suppliers' ability to purchase hedging products from ESB or other generators with a long position if they are not bringing this generation to market, supply companies will be less likely to leave the market and new companies may enter, thereby increasing competition.

Therefore, in reviewing each of the options and suggesting improvements, we focus on whether the policy proposals will provide suppliers with access to hedging products, particularly from ESB Generation, rather than an abstract notion of liquidity.

In summary (and as discussed in more detail below), the SEM Committee may be able to construct an effective policy based on Options 1 and / or 2. However, as set out in the NERA Report and our answers to these consultation questions none of the Options 3 to 5, or any variation of them, will be effective, not least due to the removal of the regulatory ring-fence.

We therefore focus the remainder of this answer on Options 1 and 2.

Option 1

The salient issues to be addressed by Option 1 are transparency and market access. We have made detailed proposals in our answer to question 1 regarding how these issues can be effectively addressed without the implementation of centralised clearing arrangements.

Option 2

The FCSO would more effectively address the competition issues outlined in the NERA Report[55] and in this response if the following changes were implemented:

1. *We recommend that the obligation should be primarily targeted on ESB to address their dominance and to improve competition in the retail sector.*

The obligation should exclude net short suppliers. The obligation on such companies will force them into a speculative net position with an even larger deficit. Selling forward contracts may also breach certain commercial constraints, increase operational costs and could force them to comply with EU financial regulations.[56]

Additionally, generation-only companies should already be incentivised to sell a high proportion[57] of their market generation forward (because they have no supply arms). Imposing the FCSO on such companies would only be justified if it was necessary to encourage them to sell forward contracts, and so increase the supply of hedging products to supply businesses.[58]

---

55 NERA (2016), section 2.
56 NERA (2016), section 3.2.2.
57 We would expect this to be in the region of c90%.
58 NERA (2016), section 3.2.2.

2. *If the SEMC does decide to oblige generation-only companies with the FCSO, it should relax the constraint that contracts be sold in a 2/1/1 ratio of baseload, mid-merit and peaking.*

Some generators primarily operate baseload capacity, whilst others primarily operate mid-merit or peaking capacity. Forcing all generators to sell contracts in ratios implied by a balanced portfolio (i.e. ESB's portfolio) forces these generation companies into speculative positions (e.g. a company sells a baseload contract when it has no baseload capacity). The SEMC should instead derive a company-specific ratio from the same data it uses to calculate each company's market scheduled quantity (MSQ).[59]

3. *The SEMC underestimates the volume of hedging contracts supply companies require, and thus calculates too small of an obligation.*

The SEMC assumes that supply companies wish to hedge 50 per cent of their expected deliveries in the all-island electricity market, discounting (1) 20 per cent to be hedged by proxy with fuel prices; (2) 20 per cent to be provided by FTRs; and (3) 10 per cent to remain unhedged for prompt deliveries.[60]

However, Ofgem has already dismissed the use of gas contracts as a suitable basis for hedging electricity price risk, due to the limited future correlation of these commodities and the lack of peaking gas products. Ofgem also noted that "smaller players may find this approach to managing their risks particularly unappealing, especially as a firm using gas to hedge a physical power position would still have to purchase power at some point".[61]

Additionally, the calculation of the 20 per cent contribution from interconnectors also appears to be excessive, because it makes no allowance for the load factors of imports into the I-SEM being less than 100 per cent (or for potential exports). There is no reason to treat interconnector capacity differently from generation capacity inside the I-SEM, whose contribution to supplier demand is measured by its actual output or MSQ. Some adjustment of the contribution from interconnectors is therefore required.[62]

Therefore, the SEMC should calculate the FCSO on the basis that suppliers wish to hedge between 70 per cent and 90 per cent of their expected delivery (depending upon the expected contribution from interconnectors).

4. *The SEMC should either allocate FCSOs and DCs administratively or design auction rules that explicitly limit ESB/EI's ability to exercise its market power.*

---

59 NERA (2016), section 3.2.4.
60 SEM-16-030, page 48.
61 Ofgem, *Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition - Draft Impact Assessment*, 12 June 2013, p.11
62 NERA (2016), section 3.2.3.

Auctioning directed contracts (FCSOs and DCs) makes no greater contribution to forward market liquidity than allocating them. Moreover, auctioning FCSOs and DCs would undermine their effectiveness in mitigating market power, as EI could bid higher prices than any other supplier, since the price in a contract between ESB Generation and EI is merely a transfer price with no implications for the profitability of the group as a whole. The Consultation provides no solution to this problem and does not explain how any solution would avoid distorting ESB's incentives.[63]

The proposed SEMC design does not allow generators to exercise market power because they are required to offer their full obligations at the administered reserve price. However, the Consultation omits any detailed consideration of the exercise of market power by *bidders* in the auctions. As NERA notes, EI may have the *ability* and *incentive* to exercise market power in the FCSO auction.[64]

EI may be *able to affect prices* in the auction. In cases where EI is the price-setting bidder, an increase in EI's bid would directly translate into an increase in market prices. In cases where EI is not the price-setting bidder, increasing the price and volume of its bid may displace lower bids and increase the clearing price in the auction.

At least when bidding for volumes below ESB Generation's obligation in the auction, EI could have an *incentive* to bid higher prices than any other supplier. On the one hand, the price in a contract between ESB Generation and EI is merely a transfer price with no implications for the profitability of the group as a whole. On the other hand, ESB would benefit from an increased price on its hedging products across its net sales to all other bidders through the FCSO. Moreover, by increasing the volume and price of its bids EI could obtain a larger share of the FCSO contracts, which would leave competitors with fewer and more expensive hedging products, undermining competition in retail markets.

The Consultation provides no solution to this problem and does not explain how any solution would avoid distorting ESB's incentives.[65]

Taken together, these four suggestions would ensure Option 2 would provide equitable access to hedging products amongst suppliers and thereby enhance competition and lower prices for consumers.

5. What is the preferred option and why do you consider it preferable?

As discussed in our answers to previous questions, and particularly question 1 and 4 above, the SEM Committee may be able to construct an effective policy based on Options 1 and /or 2, but only if the changes outlined in the NERA Report[66] and our answer to question 1 and 4 above were implemented. These suggested revisions

63 NERA (2016), section 3.4.
64 NERA (2016), section 3.2.6.
65 NERA (2016), section 3.4.
66 NERA (2016), section 3.

would ensure that the options address the competition issues outlined in the NERA Report and this response.

6. What parameters of the regulatory intervention option should be determined by the Regulatory Authorities and which should be left to market participants to determine?

In answering this question, we have tried to take into account the possibility (notwithstanding the compelling arguments set out above) that the RAs may adopt any of the Options listed in the Consultation, either as proposed or in amended form.

Scope for Input from Market Participants

Our first, high level, comment is that joint action by market participants should not be expected to "determine" many parameters. We base this comment on the observation that ESB, as the dominant firm, have very different interests from other market participants, and from electricity consumers. It will therefore be difficult for market participants to establish any consensus, particularly over interventions that are designed (as discussed above) to constrain ESB's use of market power and to disburse ESB's competitive advantage in forward markets. In this context, the SEMC will have to determine virtually all the parameters of their interventions, if only to resolve the inevitable disputes between market participants.

That said, there may be areas where market participants can provide useful guidance to the SEMC on the design of a successful intervention in trading. For instance, if the chosen option(s) mandate a rolling series of contract sales and/or purchases (i.e. either the FCSO or the MMO), market participants will be able to advise the RAs on the design criteria for these options, such as:

- the usefulness of particular contract types for hedging risks within the I-SEM;
- the relative benefits of spreading trade across all periods versus concentrating trade (and liquidity) into narrower windows;
- the benefits of allowing flexibility over the timing of mandated trades within any window;
- the process of identifying actual or forecast generation, and any associated risks; and
- the process of selecting companies to be subject to the obligations.

In relation to Option 1 participants will be able to advise the SEMC on the impacts of centralised clearing and whether it will address the trading barriers that have been identified by the SEMC during the consultation process (i.e. the need for a standard

form of contract and competitive credit terms), or whether centralised trading itself will raise further barriers to trade.[67]

In these areas, the determination of appropriate parameters, and in the case of Option 1, approaches, will depend in part on commercial factors. The SEMC can only come to understand these factors by consulting extensively with market participants, through the F&L Workstream.

Contract Prices

One parameter that the SEMC will have to determine is the price of Directed Contracts. If these contracts are to have the desired effect of constraining ESB's market power, it must be made impossible for ESB to influence their price by exerting its market power in the I-SEM's physical (spot) markets. The RAs must therefore set the prices in these contracts administratively, not by auctioning them off.[68]

By extension, we believe the same process of administratively determined prices (and allocation) should apply to all contracts issued by ESB under the FCSO, so that they achieve their desired effect.

Regulatory Procedure

As in any regulatory procedure, we would expect the SEMC's determinations to be carried out in an objective and transparent manner, taking full account of all the available evidence and submissions. The supposed tightness of the timetable cannot be used to sweep aside these requirements, or the provision for appeals against the ultimate decisions. We have a particular concern about the timing of this Consultation (published 17 June 2016) which was initially timetabled for publication on 29 January 2016, with a resulting Decision in May 2016. This represents a slippage of over five months. The timeline for a Decision has now been cut from over two months to less than four weeks to meet the 5 September 2016 Decision point, which is presumably driven by the necessity to reflect any required supplier and generator licence amendments in the Supplier and Generator Licensing Consultation which is scheduled to begin in mid-September 2016. We have a concern that these compressed timelines risk undermining the consultation process by limiting the ability of the SEMC to fully assess and take into account consultation responses.

Given the desire for flexibility, we would also expect the SEMC to provide detailed reasoning for their decisions, and an opportunity to review them at reasonable intervals. Providing detailed reasoning for initial decisions will then provide a stable and transparent basis for assessing whether any change in market conditions merits a redefinition or reallocation of obligations.

---

[67] Our views on this have been clearly set out in our answers to previous questions. In this response we have also provided an alternative solution to the problems that have been identified by the RAs.

[68] See NERA (2016), section 3.4.

Conclusion

In summary, we do not foresee that there will be great scope for a consensus to emerge among market participants over the choice of key parameters (particular as we anticipate that ESB will have different interests from its competitors and from consumers). We see the proposed forward market interventions as normal regulatory determinations. They must draw on the knowledge and experience of market participants, but will ultimately be subject to the normal requirements and constraints of regulatory decision-making. However we do have a concern that the compressed timeline for decision-making (ultimately resulting from a five month slippage to the publication of the consultation) risks undermining the consultation process by limiting the ability of the SEMC to fully assess and take into account consultation responses.

Annex 1: Key concerns about vertically re-integrating ESB

1. Any re-integration of ESB's ring-fenced units presents a real risk to consumer interests and should be rigorously assessed by the RAs for its impact on competition. The relevant Competition Authorities (CCPC in ROI, CMA in UK) with responsibility for merger assessment should be consulted given their extensive experience and expertise in the area of mergers and joint ventures. There is no evidence that the competition authorities have been consulted so far in the process, no response from any competition authority is published along with other responses to SEM-15-094.

2. In 2011, the Irish Competition Authority (now CCPC) submitted a formal response for public record to the SEM Committee when the re-integration of ESB was considered in the Consultation on Market Power and Liquidity in the SEM (SEM-11-003).

3. In that paper, the Competition Authority expressed the view that a re-integration of the ESB's ringfenced businesses, including vertical reintegration of its generation and retail supply business would give rise to competition concerns. Furthermore, although a reintegration of the ESB's ringfenced units would not be a notifiable merger under the Competition Act 2002 in its view, it "*should nevertheless be assessed by the regulatory authorities for its impact on competition*". The Authority noted in this regard that it "was the public body with responsibility for merger assessment in the State [with]… extensive experience and expertise in the area of mergers and joint ventures" and it strongly advised against any re-integration of ESB's ring-fenced businesses at that time. According to the Competition Authority, "…the source of ESB's market power in the SEM is derived primarily from its ownership of a diverse range of power generation plants".

4. The merger of any other generation business similar to that of ESB's, with an independent supply business of the same scale and scope as ESB's would be subject to merger control approval, if not by the European Commission, then by the CCPC in Ireland and the CMA in the UK. How the vertical re-integration of ESB would fare under the merger control substantive test(s)[69] is directly relevant therefore to determining whether it is an appropriate measure. There is every reason to believe that such a merger would not pass the relevant substantive merger control tests and that merger control competition authorities would look to substantial conditions before approving any such integration, including in particular divestment of appropriate generation units and segments of its customer base. This is because ESB remains dominant and as outlined by the Competition Authority in its July 2014 submission to the Green Paper on Energy Policy, "given that it is the biggest generating company in the SEM, ESB

[69] Namely in Ireland and the UK, whether the merger would lead to a substantial lessening of competition or, at EU level, whether the merger would significantly impede effective competition, in particular as the result of the creation or the strengthening of a dominant position.

continues to have a pivotal role in the determination of market prices". This finding is consistent with the RAs' own observations:

a. ESB retains a generation market share (MSQ) of nearly 47 per cent and is the only pivotal generator in the All-Island electricity market according to the RAs own modelling (SEM-16-024, p39).

b. As the RAs have noted, the geographic market for I-SEM is restricted to the island of Ireland and any competition in wholesale markets from outside the Island of Ireland will be restricted by the available interconnector capacity (SEM-15-024, p18, para 3.3.2). And that furthermore, in the absence of market coupling in the Intraday Market and/or a common merit order list in the Balancing Market, the use the interconnector capacity in these two timeframes may be restricted, reducing the size of the relevant geographic market (SEM-15-024, p18, para 3.3.3).

In Case COMP/M.5224 - EDF / British Energy, the European Commission had significant concerns that the position brought about by the merger in generation was likely to lead to an increased internal use of electricity by the parties that would otherwise have been sold to the market, leading to a reduction of liquidity with negative effects in both the wholesale and the retail supply markets. This concern was addressed, in part, by the parties' commitment to divest two of the parties' power generation plants.

5. Were the RAs to conduct an assessment of the competition impact of the removal of ring-fencing, they would be very likely to conclude that ESB's ring-fence should be retained. The reasons CEPA cited for favouring ring-fencing in 2012 apply just as much in the I-SEM as in the SEM and ESB's arguments provide no grounds for concluding otherwise:

- As the RAs themselves acknowledge in SEM-16-094; "that there is likely to be less transparency to the wider market in I-SEM. For example, all bids and offers in the current SEM are published within a number of days to the wider market. It is likely that only anonymised aggregate bid curves for the ex-ante markets in I-SEM…"[70]

- The ring-fence will continue to help to protect forward-market liquidity, by forcing Electric Ireland to trade forward products through the market. Proxy-hedges or building new plant are costly substitutes for financial contracts signed against Irish electricity prices and are insufficient to promote competition in retail markets[71]. Trades resulting from the ring-fence may be additional to those created by the market maker obligation or not: to the extent the ring-fence overlaps with any future market maker obligation imposed on ESB, it will not impose additional costs;

---

[70] SEM-16-094, paragraph 8.12.22, p62.

[71] This is only possible for example if ESB's customers are significantly 'stickier' than other suppliers'.

- Foreclosure of the market remains a serious concern in the I-SEM. ESB's comparisons with GB in its response to SEM-15-094 are specious: The British market, which consists of six large competing players, is much less concentrated and all market participants need to trade because they do not have a diversified and balanced portfolio. ESB is the sole dominant player in the Irish market with a large diverse portfolio of generation and a relatively balanced generation and supply business which mitigates its need to trade with other market participants.

- ESB and Baringa (in response to the MPM consultation paper SEM-15-094) place their faith in REMIT to prevent a vertically-integrated ESB from making use of informational advantages. In practice, REMIT may not cover all of the information that could provide an advantage to Electric Ireland and the breadth of its coverage within the electricity sector is currently unclear, regulatory solutions are also unlikely to be as effective as a structural solution.

- Furthermore, as NERA state:

  "…REMIT has nothing to say on the publication of information about the regulatory and pricing strategy of dominant firms. REMIT may oblige traders to report their trades, but withholding supply to raise prices requires a decision not to trade, which would not be reported" (NERA Report, p5).

  "…ESB has market power in the generation industry, and as a result has an informational advantage over other potential traders (a case of "informational asymmetry" which is not addressed by REMIT). (NERA Report, p11)

- Vertical separation allows for a degree of much-needed transparency to the operations of ESB and is accordingly a key-enabler of RAs' regulatory role including market surveillance.

6. Against the compelling case to retain ESB's ring-fence, ESB in their response to the MPM consultation paper SEM-15-094 provide no evidence as to how its removal would improve competition and ultimately consumer welfare. ESB's submission is at worst, purely rhetorical and, at best, unsupported statements of its position. In particular:

   a. ESB asserts that the ring-fence is discriminatory. Discriminatory regulation involves treating similar entities differently (or different entities similarly) without objective justification. It is not discriminatory to impose targeted obligations on ESB when ESB is uniquely placed to distort competition in the I-SEM.

   b. ESB alleges that it will save significant costs from removal of the ring-fence but does not provide any evidence to show that these costs would in fact be avoided. Nor does ESB demonstrate that these costs would or

have been passed through to consumers – which is unlikely in an uncompetitive market [72]. Many important market power mitigation schemes impose costs on the affected firms, but the benefits for consumers still exceed those costs.

7. In July 2014, the CCPC's predecessor, the Competition Authority, described ring-fencing as a "second-best option in addressing the issue of high concentration in generation and vertical integration", the best option being "structural remedies [i.e., divestments]". In the absence of divestments, ring-fencing remains accordingly necessary in SEM and I-SEM and its removal would likely substantially lessen competition, including by reinforcing ESB's position of dominance in vertically integrated markets. Under the EU Treaties, Member States including their authorities, shall refrain from any measure which could jeopardise the attainment of the Union's objectives, including competition law objectives. More particularly, it appears to us that removing ESB's ring-fencing obligation would be contrary to Article 106(1) of the Treaty on the Functioning of the European Union in combination with Article 102 as it would re-place ESB, a public undertaking, in a position such as to lead inevitably to potential abuses and ineffective competition.

[72] This is only possible for example if ESB's customers are significantly 'stickier' than other suppliers'.