NORTHERN IRELAND ELECTRICITY plc

Single Electricity Market

Risk Management in the All-Island Single Electricity Market

AIP/SEM/122/06

NIE's Response

13 October 2006.

1. Summary

The consultation paper briefly discusses risk management in general, but specifically focuses on potential ways of facilitating risk management transactions in the all-island electricity market (SEM). NIE's response concentrates largely on the latter.

The consultation paper considers three options for the regulatory authorities' (RAs) treatment of the contract market:

- Do nothing – which the RAs believe "is unlikely to result in the early development of a transparent, liquid, non-discriminatory contracts market in Ireland."
- Direct ESB's Power Generation and NIE's Power Procurement Businesses (ESBPG and PPB) to post offers formally on web-based platforms. The RAs consider that, while this would establish a formal system and give the RAs some control over it, "the trading platform would be developed by and be under the control of the two dominant sellers of derivatives in the market [and] again, it is debatable whether this would lead to the development of a transparent, non-discriminatory derivative contracts market."
- Procure a third party platform – which the RAs think would have advantages in transparency, anonymity, non-discrimination, credit risk and financial regulation, and would not obviously be more costly than the other two options.

The structure of the SEM pricing is such that of the various cost elements for a supplier, the only volatile element is the SMP. Capacity payments, imperfections charges, ancillary services, SMO charges, PSO, SSS, etc, are all effectively tariffs.

Furthermore, the SMP volatility should, if the bidding principles apply, have a close correlation to fuel price movement and hence should follow a rational path. Nonetheless, retailers will not want exposure to fuel markets and will want their position hedged via CfDs (in the absence of being able to link the SMP to a fuel mix).

Most of the supplier contracting activity is likely to occur prior to the tariff year and it is not apparent that suppliers will undertake a dynamic trading position in the early days of the SEM. However, the need for greater liquidity will no doubt eventually emerge as suppliers seek to tailor cover in response to market fluctuations.

In terms of the options, NIE believes that the only practical method of developing an appropriate, contracts market is via a participant-led initiative.

There is strong evidence from other similar markets (eg old E&W pool) that contracting markets will develop through the market participants joining together to develop suitable arrangements and platforms. The benefit of such co-operation is that; the market is fit for purpose and supports the needs of all the participants, the solution is efficient and transaction costs are minimised, market liquidity develops naturally in response to the market requirements, and a set of commonly traded products may be developed jointly.

An imposed solution on ESBPG and PPB would not result in the best long term interests of a market with concerns about dominance. It would seem more appropriate to place obligations on the parties to offer contracts to the market (the contracting principles NIE espoused in an earlier response on market power mitigation) to help ensure there is adequate liquidity for retailers (and generators).

RA procurement also appears to be an unwise option since that would incur costs for a solution that may receive little use initially. It would seem better to wait and if the exchanges and brokers felt there was sufficient business to warrant extending platforms into the Irish market, no doubt they would voluntarily enter the market (the costs of such extension may well be low for a third party host but the volume of transactions is likely to be critical to determine viability and hence this is something that may evolve as the market develops). This incremental market based approach would seem to provide the most cost effective solution.

One important dimension of facilitating a market for contracts is the development of a robust framework contract that could underpin all risk management arrangements. We believe that the RAs can perform an important role to this end by facilitating the development of such a framework contract, not only for the directed contract market, but one that meets the requirements of wider risk management transactions.

The process of participants engaging collectively on risk management arrangements could be primed through a number of workshops facilitated by an appropriate independent consultant. Possibly a practical way to initiate this would be to utilise a consultant from the panel currently supporting the SEM programme.

In summary, NIE recommends that:

(i) participants (particularly retailers) lead the development of the risk management products to ensure they are “fit for purpose” and in parallel, participants develop the appropriate generic contractual arrangements that will meet the requirements of all products including directed contracts; and

(ii) the costs and appetite of 3rd parties to provide a service should be explored.

2. Additional Comments

~~2.1~~ General

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NIE does not consider that either it or the RAs have the necessary information about these forms of regulated markets to conduct the regulatory impact assessment that would be needed to make a more detailed judgement on the options.

It is possible however that the setting up of a 3rd party platform may not involve much by way of development cost, since vendors should be able to extend easily. But it is not clear the use of resources and volumes would deliver the margins and necessary business case needed to motivate a vendor to initiate. NIE would also question whether the benefits of a centrally managed market such as option 3 would be as effective as the RAs appear to assume.

ESBPG and PPB can be asked to provide initial estimates of costs of the second option and third party providers can be asked for indicative estimates of the third. In both cases, there would be a problem of providing a costing without having a detailed specification but the parties could be asked to describe the (relatively simple) system they were costing.

The European Commission preliminary report on competition in the European gas and electricity markets, which the RAs quote, identified a number of problem issues relating to electricity wholesale markets - concentration and market power (dominance), vertical foreclosure (reduced volume as a result of generator/supplier vertical integration), lack of market integration (between different country markets), lack of transparency, and prices. The first three of these issues are present in the SEM and none of them is affected by the platform chosen for the wholesale contract market.

The RAs have developed a strategy to address the first (dominance). The second is a common feature in markets (e.g. Britain, New Zealand, and Sweden) where unbundling has taken place and supply is separated from distribution. Vertical integration of generation and retail is a natural response to the risk of the wholesale spot market. It is difficult for supply businesses or generation businesses[1] to operate in isolation as failures in the British market have proved. This is all the more the case if there is market dominance.

The lack of integration of the SEM with other markets is primarily a physical problem. The concern over prices is more related to a consequence of the issues than to a cause. Only the fifth issue – transparency – is clearly related to the organisation of the contracts market.

[1] Other than those with long term contracts (and so effectively vertically integrated) with supply businesses.

The RAs suggest that an administrated market would increase transparency, preserve anonymity and (mainly as a result of those two features) better ensure non-discrimination. However, the extent to which this is true is limited.

Transparency can be obtained through reporting requirements under any of the three options. It is true that it is only in option 3 that the reporting would be done by a third party but reporting by generators could be audited.

Anonymity in trades can only occur if credit risk is managed by a central mechanism, as in option 3. The RAs identify credit risk management as a further advantage of that option in that counterparty risks are pooled and so minimised. However, markets normally have credit rules with associated transaction costs.

Non-discrimination is more difficult in an anonymous market because a seller cannot identify a buyer in order to set different terms to the sale. However, that sort of discrimination (between two buyers that are both unrelated to the generator) is a comparatively minor problem. There is no significant advantage of option 3 over option 2 where the discrimination is between sales within a vertically integrated company and other sales. This is because the former can have different terms implicit in the unwritten internal contract.

2.2 Detailed points

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Section 2:

It is not necessarily the case that prices are volatile. Given an appropriate set of trading rules and commercial arrangements, prices are cost reflective. The underlying commodity cost reflects that of the supply / demand balance and hence may show peaks at times of high system stress. However, such peaks are a natural response to the demand and generation mix. Consequently, the main risks to SEM participants are price and volume risks and the risk management approach taken should be focussed on mitigating these risks.

The response to weather derivatives has been very mixed in NETA and very few of these products have been traded. Not all demand is weather dependent and only the domestic demand shows a strong correlation to such factors.

Section 3:

This section defines each of the various contract types that can be used to hedge market positions. This appears to be for informational purposes only and does not discuss the merits of each of the hedging options in relation to the SEM and which would be appropriate to SEM participants given the regulatory environment and vertically integrated structure of participants.

Furthermore, it should be noted that each of the contract types discussed, either traded OTC or via a broker, has a cost in taking out and holding the contract. It is unclear what the RAs' position is on incorporating the cost of hedging into the electricity prices ultimately paid by consumers and businesses. Clarity from the RAs is needed with regard to the allowed mechanism for cost recovery of market hedging costs.

Paragraph 3.4.1 – The option fee is a function of the capacity in the market and the level of expected volatility.

Paragraph 3.5 – We agree that it is difficult to imagine that there will be large numbers or large volumes of contracts traded initially in the all-island market due to the high level of vertical integration.

Section 4:

Paragraph 4.1 - An efficient and well functioning contracts market may be necessary but would be developed by a set of participants if they felt it would lead to a more efficient managed risk position. The cost of such a market and set of commercial agreements could evolve as participants identified a clearly defined business and commercial need.

Paragraph 4.2 - Little benefit is gained from this approach as the dominant market operators are still involved in the process and there is little opportunity to increase transparency. Costs for such an approach should be shared by all market participants not just the generators discussed.

Paragraph 4.3 - Again the small number and volumes of trades may not justify the cost such a venture and it is difficult to understand how the RAs (or the market generally) could guarantee a volume of trading for the operator to recover the set-up development and operational costs.

An alternative option could be to extend an existing power exchange or brokerage arrangement to cover the All Island Market participants. This would provide a number of advantages:

- Established infrastructure and processes
- Established contractual arrangements
- Lower cost to implement
- Increased speed to establish market risk mitigation arrangements

This arrangement could be achieved as extending an existing exchange/brokerage or procuring the services of an existing exchange/brokerage to provide the same services to the SEM.