



**Market Monitoring in the SEM: Scope of the MMU and interaction
with Market Participants and other Interested Parties**

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INFORMATION PAPER

Summary

The Market Monitoring Unit (MMU) is an integral part of the Regulatory Authorities' (RAs') Market Power Mitigation strategy developed during 2006.

This paper aims to define the relevant boundaries between the spot market and the contract markets, and the relevant boundaries between the responsibilities of the RAs (including the MMU), the competition authorities and the financial authorities; as well as setting out how the MMU expects to interact with market participants.

The work of the MMU will be carried out primarily from the Utility Regulator's offices in Belfast though staff at CER will be fully aware of the work of the MMU. Participants may communicate directly with their own regulator in relation to market monitoring.

The MMU will monitor the performance of the SEM on an ongoing basis in order to understand and assess how prices are being set and whether those prices are at a level that would be expected in an effectively competitive market.

The RAs reaffirm that the MMU will actively monitor the spot market rather than the contract market. However, on occasion it may be necessary to ascertain participants' net hedging positions to understand behaviour in the spot market.

The MMU will be receptive to informal communications intended to direct the RAs' attention towards particular events or patterns which participants feel would be of interest to the RAs.

It will also be possible to, through the MMU, formally request the RAs to investigate the behaviour of a market participant. Annex A of this paper sets out

how the RAs expect to deal with such a request. Communications of this sort would in normal circumstances be published.

The RAs intend to establish a forum which allows participants to communicate their views of market developments.

Introduction

The Market Monitoring Unit (MMU) forms part of the Market Power Mitigation strategy developed by the RAs during 2006. Full details are contained in the Decision paper *Market Monitoring in the SEM* (AIP/SEM/217/06) published in December 2006 and the initial Consultation paper (AIP/SEM/143/06). These papers defined the role of the MMU as:

- Market Monitoring including publishing quarterly market assessments.
- Investigations into the exercise of market power – including but not limited to the violations of bidding principles or other market rules.
- The point of contact within the RAs for well documented complaints that upon investigation appear to have a sound basis.¹
- Making recommendations as to modifications to the Trading and Settlement Code which the RAs should initiate.

The Decision Paper committed the Market Monitor, on appointment, to publish a document that:

- defined the relevant boundaries between the spot market and the contract markets, and the relevant boundaries between the responsibilities of the RAs (including the MMU), the competition authorities and the financial authorities; and
- Set out guidelines on how the MMU expects to interface with market participants.

¹ The Decision Paper made it clear that the MMU will have no enforcement authority and is not an adjudicatory body. While it would likely establish processes for its own uses, these processes would not be formal investigative processes. The RAs will adjudicate complaints through the joint regulatory arrangements according to their standard processes. If the MMU declines to forward a complaint to the RAs on a fast track basis, this will not prejudice any right of the complainant in any forum including going to the RAs directly.

This paper meets that remit.

As emphasised in the Decision paper *Market Power in the SEM: Market Monitor Identity* (AIP/SEM/82/06) market monitoring investigations and submission of Trading and Settlement Code modification proposals to the Modifications Panel will be carried out by the RAs. The MMU will monitor the performance of the SEM on an ongoing basis in order to understand and assess how prices are being set and whether those prices are at a level that would be expected in an effectively competitive market. This ongoing monitoring of the SEM will assist the RAs in their assessment of the performance of the SEM.

The MMU is an integral part of the RAs and does not operate outside their structures. For convenience this paper refers to decisions and recommendations of the MMU – in practice these are actions of the RAs.

The Market Monitor is one of the four identified Joint Management Units (JMU) located in Regulatory Authority offices in Belfast and Dublin which will be governed by the Joint Regulatory Arrangements. The four JMU units are:

- Market Operator regulation
- Market Modelling
- Trading & Settlement Code
- Market Monitoring

It has been agreed that the work of the MMU will primarily be carried out from the Utility Regulator's offices in Belfast. However, staff within the CER, at all times be aware of the ongoing work of the unit and will assist the MMU carrying out its functions as required. Participants may if they wish communicate directly with their own regulator in relation to market monitoring however all decisions of the MMU will be made and implemented jointly by the RAs.

Recommendations from the MMU will be confirmed or rejected by the SEM Committee.

The RAs have developed internal procedures to ensure that the necessary organizational structures and operational arrangements are in place to support effective decision making in the SEM and the work of the SEM Committee.

Scope of MMU oversight

The RAs indicated in the Decision Paper that they had established the MMU to serve a specialised function of monitoring the SEM spot electricity market to ensure that it produces the outcomes which would be expected in a competitive market. This is the MMU's primary role.

Spot and contract markets

Contract markets that will form around the SEM spot market will not be mandatory and will not share the special characteristics of electricity spot markets (e.g. inelastic demand at any particular time). Parties have freedom to contract on any terms. Contract prices are mutually agreed prices and not prices established by a clearing price formula. However, the MMU may review the contracting activity by dominant generators through the monitoring of compliance by such generators with their licence conditions.

A well functioning spot market is the best way to discipline the contract market. These factors also militate against the need to monitor the contract market. Moreover, the contracts market will be subject to the same controls as markets in the rest of the economy (e.g. competition law and financial regulation, as appropriate).

Manipulation of the spot market can potentially be effected through the offers submitted to the Market Operator and the physical availability of plant.

Generators can manipulate pool prices through financial withholding (i.e. bidding at uneconomically high prices) or physical withholding (i.e. declaring capacity unavailable when there are no engineering or technical reasons for doing so), both of which cause prices to rise above competitive levels, or price suppression (i.e. bidding in at uneconomically low prices). It is also possible that generators

would attempt to manipulate when they were scheduled to run by altering their start-up costs so that they did not reflect the true characteristics of their plant.

Financial withholding and price suppression would put generators in breach of the licence obligations, while physical withholding would cause generators to be in breach of their Grid Code obligations.

Generators and suppliers will probably enter hedging contracts, whose value will depend on the SMP in the pool. Generators' potential incentives to manipulate pool prices will depend on the degree to which they are hedged. Because incentives to manipulate depend on net hedging positions it is likely that where the MMU is investigating a particular instance of suspected market manipulation the RAs will wish to understand the net hedging position of generators, and may ask for this information from participants on an ad-hoc basis.

To summarise, the MMU will actively monitor the spot market. Nonetheless it may on occasion require licensees to provide information on net hedging positions to inform the RAs' understanding of behaviour in the spot market.

Boundaries between the RAs, the Competition Authorities and the Financial Regulators

As already noted, the RAs envisage that market participants will hedge their pool exposures through CfDs, which are financial contracts. Depending on how these are structured these may be subject to regulation by either the Financial Services Authority in the UK (FSA) or the IFSRA (Irish Financial Services Regulatory Authority) – though in both jurisdictions there are exemptions relating to instruments which are entered into for purely risk management purposes. It is for market participants to satisfy themselves whether their activities are subject to regulation by the various financial regulators.

Manipulation of the contracts market would not necessarily involve a breach of a licence condition or other SEM rules. However, as stated in the Decision Paper on market monitoring, hedging markets are subject to the competition rules relating to the rest of the economy. The body with primary responsibility for enforcement of competition law in the UK is the Office of Fair Trading (the OFT). As a sectoral regulator, the Utility Regulator has the same powers in relation to breaches of competition law in the electricity market as the OFT has in all cases. Although the Utility Regulator has competition enforcement powers, the CER does not. The CER has legal duties in relation to the promotion of competition and a co-operation agreement in place with the Competition Authority to avoid duplication of work and facilitate co-operation in general with regard to competition and ensure consistency in relation determinations relating to competition.

As the MMU will be monitoring outcomes on the spot-market, in which specific market rules apply, it is not envisaged that the MMU recommendations to the SEM Committee will rely on the competition powers of the RAs.

The RAs are keen to ensure that a liquid market for hedging instruments based on SEM pool prices develops. For the first year of the SEM the RAs have facilitated the auctioning of some CfD contracts by ESB Power Generation and the Power Procurement Business.

Interaction with market participants and other interested parties

International experience has shown that market monitoring benefits greatly from interaction with market participants and other interested parties, who have a direct interest in ensuring that they are not disadvantaged by other participants' behaviour.

It is hoped that in carrying out the RAs' functions in the SEM, the RAs will be in a position to benefit from this type of interaction. To this end the RAs intend to facilitate communication between market participants and the MMU, and see this as an integral part of the MMU's role.

The MMU envisages facilitating easy communications with market participants outside investigations into particular events or market behaviour and will be receptive to communications from either participants or other parties which are intended to direct the RAs' attention towards particular events or patterns which they feel are of interest. In informal communications of this nature the MMU would not be obliged to provide feedback as to how the RAs were taking the information forward or whether the RAs felt such information warranted further investigation. In the normal course of events such communications to the MMU would not be published, though they may of course be covered by relevant Freedom Of Information obligations in either jurisdiction.

In addition to publishing quarterly market assessments, the RAs intend to establish a forum in which the MMU outlines its view of developments in the market and participants can communicate their views. Regular meetings of this type with industry are a useful tool for gauging how participants feel the market is developing. The location of these meetings will be shared equally between Dublin and Belfast.

It will also be possible to formally request the RAs to investigate the behaviour of a market participant through the MMU. As was made clear in the MMU Decision paper, complaints of this nature will, in normal circumstances, be published. The MMU expects that any such submissions made to it will be clearly and cogently argued, clearly showing which market rule or licence condition was being breached, and insofar as practicable, estimating the impact. The MMU would then, if appropriate, conduct an investigation within a certain timeframe into the alleged misconduct and make recommendations as appropriate to the SEM Committee. Annex A sets out a series of procedures which the MMU requires formal complaints to follow.

Investigations

A decision to initiate an investigation is the outcome of the understanding of the SEM which the MMU will develop in the course of its work. On an ongoing basis the MMU will both be examining market outcomes and assessing bids for consistency across time and with similar plant or what would be expected given the known characteristics of the plant.

There are two obvious types of investigations which the MMU could be expected to conduct (though they are not necessarily mutually exclusive):

- Investigations into particular events (such as price spikes)
- Investigations into the behaviour of particular participants (e.g. for breach of market rules).

Where the MMU is investigating the market behaviour of a market participant, it will often be in close contact with that participant. Initially, this may simply be a request to explain the bidding behaviour in the SEM, or a request relating to the reasons for forced outages.

As the MMU is part of the RAs it is open to the MMU to ask generators to justify their bids (which must be in line with the Bidding Code of Practice), and to utilise the full extent of the powers granted to the RAs under the legislation creating the SEM.

Should an investigation lead to the need for enforcement action or directions in relation to bids, this will be carried out under the rules and legal framework applying in the relevant jurisdiction.

Bidding Code of Practice

All generation licencees North and South must comply with the published *Bidding Code of Practice* (AIP/SEM/07/430). Bidding principles form one of the key elements of the Market Power Mitigation strategy developed for the SEM.

Ongoing market developments might lead to it becoming desirable to modify the Bidding Code of Practice. Where it feels that it is appropriate, the MMU may recommend to the SEM Committee that it initiate a change in the Bidding Code of Practice. The procedures for making amendments are as detailed in the Bidding Code of Practice itself and will be subject to public consultation.

Relevant Personnel

The MMU will be based in Belfast at the Utility Regulator's offices. The MMU team will be primarily responsible for the production of market assessments and the investigation of specific complaints.

Queries relating to ongoing market monitoring should be directed through the MMU at Belfast. The relevant individuals are:

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MMU Manager:	Tadhg O'Briain
MMU Analyst:	Paul Bell
MMU Analyst:	Andrew McCorriston

A market participant or other interested party may direct a relevant query through their local regulator.

The relevant CER personnel are:

Manager Generation:	Sheenagh Rooney
Analyst Generation:	Dana Kelleher

At all times relevant staff in the CER will be fully aware of the ongoing work of the MMU (through the agreed Joint Regulatory Arrangements) and will work on MMU tasks when deemed appropriate by the RAs.

Conclusion

The MMU will operate primarily from the Utility Regulator's office in Belfast but with CER staff closely involved with its work. It will actively monitor developments on the spot market for electricity on an ongoing basis in order to understand and assess how prices are being set and whether those prices are at a level that would be expected in an effectively competitive market.

The MMU's main focus will be on the operation of market rules (broadly understood to include licences and grid code obligations) rather than concerns arising under competition law. Current arrangements in relation to competition law in the electricity industry – which differ North and South – will continue in the SEM.

The MMU will facilitate both formal and informal communication in relation to developments in the SEM:

- Informal: The MMU will be receptive to communications intended to direct the RAs' attention towards particular events or patterns which participants feel are of interest.
- Formal: It will also be possible to through the MMU formally request the RAs to investigate the behaviour of a market participant. Communications of this sort will be published.

The RAs also intend to establish a forum to facilitate communication between the MMU and participants on market developments.

Annex A

- 1) In order for the MMU to receive a formal complaint to which it can give proper consideration, the person or entity making the complaint (the Applicant) must comply with the following essential requirements (the Requirements):
 - (a) The application regarding the complaint must be made in writing (which may be submitted either in hard copy, facsimile transmission or in emailed electronic form);
 - (b) The application must identify the provision within the legislation, licence or other document under which the SEM Committee is given jurisdiction to consider the complaint; and
 - (c) The application must contain detailed information and supporting evidence regarding the basis of the complaint or dispute **and** the manner in which the Applicant is affected.
- 2) If the MMU considers that an application does not comply with the above Requirements, it reserves the right not to treat that application as having been properly received as a formal complaint for the purposes of the relevant legislation. The MMU may advise the Applicant to submit a complete application which complies with the above Requirements.
- 3) If the MMU considers that the RAs do not have jurisdiction, or that the RAs are otherwise not appropriate, to consider the formal complaint in question, it will reject the application and inform the Applicant accordingly.
- 4) As soon as practicable after having received an initial formal complaint the MMU shall acknowledge receipt.
- 5) At the same time as it complies with paragraph 1 above, or shortly thereafter, the MMU shall endeavour to:

- (a) Categorise the application as either a valid complaint which is suitable for investigation by the MMU and,
 - (b) issue to the applicant an indicative timetable for the matter's consideration – this will outline each stage of the process and the times specified by the MMU by which the MMU expects to have received replies (as required on a case by case basis); or,
 - (c) reject the application on the grounds referred to in either of paragraphs 2 or 3 (in the event of having received an invalid application or an application in respect of an issue that the RAs considers would be better resolved by other means).
- 6) The MMU will ordinarily conduct a preliminary investigation to establish whether the matter is one which it can consider.
- 7) If a formal investigation is required, the MMU will endeavour to complete an investigation for submission to the SEM Committee within 2 months of receiving the application.
- 8) However, where the MMU considers it necessary to request further information or evidence in order to assist consideration of the matter, or considers that an extension of time is essential in furtherance of the SEM Committee's statutory obligations, powers, or objectives, this period of time can be extended.