

**RESPONSE BY BORD GÁIS ENERGY**

**To**

**I-SEM MARKET POWER MITIGATION  
CONSULTATION PAPER  
(SEM-15-094)**

**18<sup>TH</sup> JANUARY 2016**

## Section 1: Introduction & Summary

Bord Gáis Energy (BGE) welcomes the detailed analysis and proposals presented as part of the SEM Committee's Consultation Paper on ISEM Market Power Mitigation. In particular, the dynamic analysis presented, using a combination of the Residual Supplier index and the Herfindahl-Hirschman index, is very useful in understanding how market power will change with the introduction of multiple market timeframes and increasing levels of variable generation and demand.

BGE is concerned however that market power in the **forward market** is dismissed and that detailed analysis of the forward market has not been presented in the Consultation Paper.

In BGE's view, the forward market is defined too broadly and therefore the potential for market power abuse is underestimated. In Section 3 below we outline in detail why we believe: a) the forward market is a narrower market than that proposed in the Consultation Paper; b) the forward market is susceptible to market power abuse; c) the European financial regulations will not address this market power, and d) the ring-fencing arrangements in place do not remove the incentive to abuse a position of market power in the forward market.

Given the role of the forward market in enabling competition in the retail market and in providing price stability for customers, we urge the SEM Committee to consider the forward market further and to address the potential market power risk with the same rigor as applied to the physical energy markets. Although the solutions for market power in the forward market may be best addressed through the liquidity work-stream, the process of identifying and monitoring market power in the forward market must in our view be established as part of this Market Power Mitigation work-stream.

In considering the best combination of the **mitigation tools** presented in the Consultation Paper for the physical energy markets, BGE tries to balance the objective of this Market Power Mitigation work-stream with the need for incentives to trade, and therefore the provision of liquidity, across all market timeframes. Given that the three physical markets (day-ahead, intra-day and balancing markets) are inherently inter-linked and therefore are not discrete markets, the principles that apply to each must be the same. If separate approaches or principles are applied it will simply create arbitrage between the market timeframes with the potential to diminish liquidity in one or more of the market timeframes.

Whereby we recognise and agree that the risk and effect of market power abuse is greatest in the balancing market, we are of the view that applying a more stringent set of bidding rules in the balancing market (i.e. different to those in the day-ahead and intra-day markets) would cause a divergence of incentives to trade for generators and suppliers. This in turn would likely hamper liquidity, especially in the intra-day market. We therefore believe that a clear set of bidding principles (that considers the interaction of the physical markets with the capacity and ancillary services markets), with powers for the SEM Committee to direct changes in bids and to collect compensation from parties where bids are found to be non-compliant with the bidding rules, is the best mitigation option for ISEM Go-Live.

Lastly, in considering the potential to relax the **ring-fencing requirements** we suggest that the SEM Committee consider: a) the market positions of the integrated entities in both the wholesale and retail markets; b) the ability of either/both business units to use information gathered by the other to abuse a position or discriminate between parties, and c) the impact that this discrimination may have on competition. Whereby the Competition and Markets Authority (CMA) review of vertical integration and foreclosure in the British market is interesting, we need to consider the differences between our markets before accepting its conclusions. In particular, we need to consider how the size of the ISEM market and the level of concentration in the ISEM market affects the *incentives* for incumbent integrated utilities and *opportunities to trade* for independent parties.

In BGE's view, it would not be appropriate to change the ring-fencing requirements currently in place for ESB. Given the SEM Committee's analysis of the likely evolution of spot market power and our view of market power in the forward market, we believe that ring-fencing arrangements will be required in the ESB for the foreseeable future.

## Section 2: Context for Market Power Policy Development

1. *Do you agree with the policy developments and trends identified (above) as potentially impacting on an I-SEM market power mitigation strategy? Are there other factors not identified here which you consider relevant?*

Market and policy across Europe is changing continuously and will inevitably continue to do so to align with developing EU policies such as Europe's climate change ambitions. Whereby BGE recognises that we need to design a market that is flexible enough to facilitate changing technologies and participation, the primary objective of the design of the market power mitigation strategy must be to address market power issues that **currently** exist and that will persist in the foreseeable future.

Given technology, capacity and cost constraints, BGE does not believe that interconnector capacity and/or demand side participation are effective market power mitigants for the foreseeable future as is evident from the SEM Committee own modelling outlined in the Consultation Paper. This modelling also provides an interesting insight into the impact of renewable generation on the dynamics of the market. Specifically, it clearly shows that an increase in intermittency, associated with increasing levels of wind penetration, will actually enhance the position of those with market power within an increasingly dynamic market with multiple bidding opportunities. Therefore, along with interconnectors and demand side participation, renewables will have little or no role to play of itself in mitigating market power abuse in I-SEM.

With respect to the Regulation on Energy Market Integrity and Transparency (REMIT), BGE has spent considerable time and resources implementing systems and processes to comply with REMIT, however we do not believe that it will be effective in mitigating the type of market power that has been identified and that will exist in the ISEM.

REMIT will be helpful in providing transparency and information to assess market power, but only after the fact where market power abuses have been identified. It **will not** in itself be effective in identifying and therefore preventing short term and transient market power abuses. That is, given the dynamics of the ISEM and specifically the risk of market power being abused in the shorter-term intra-day and balancing markets, and the impact of even such a short term abuse on prices and costs, BGE believes that the role of REMIT will be very limited within the context of a market power mitigation strategy for ISEM. The European Commission's 2007 [Recommendations Paper](#)<sup>1</sup> relating to the electronic communications sector is relevant in this regard. Within that paper, the European Commission sets out criteria under which markets would benefit from ex-ante regulation. It specifically recognises that legislative provisions may not be sufficient "where the compliance requirements of an intervention to redress a market failure are extensive or where frequent and/or timely intervention is indispensable". REMIT's role will be limited purely to the confines of supporting the MMU's ex post monitoring role.

Other policy developments not expressly considered in this section relate to the increasing interactions between the energy, capacity and ancillary service markets and the implications of these interactions for market monitoring. Given the different but sometimes complementary objectives of the various markets, in particular the energy and the ancillary service markets, assessing and determining cost reflective or competitive bidding behavior will be less straight forward and transparent. These interactions and the implications the exercise of market power in one of these markets can have in another must be borne in mind in finalizing the I-SEM market power mitigation strategy.

Lastly, given the aggressive timeframe for the implementation of a market power mitigation strategy, and its importance for the realisation of a competitive ISEM and market outcomes, it is imperative that the agreed solution can be implemented effectively ahead of market Go-Live in 2017. From a policy perspective, given the interactions between the energy and capacity markets, market power in each and the likely need of clearances from the European Commission, the market power mitigation solution must be simple, transparent and workable in limiting the opportunities for parties to exercise market power while also minimising direct intervention in the market. We will revert to this further in Section 8 below.

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<sup>1</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32007H0879&from=EN>

### **Section 3: Relevant Geographic Market(s) and Trading Period(s)**

2. *Do you agree with the proposed appropriate markets/trading periods for assessing market power in I-SEM's energy and financial markets?*

Market definition is a tool that provides a framework for assessing competitive constraints faced by firms. The methodology applied by the SEM Committee is the right one: testing whether a small price increase could be profitably sustained by a hypothetical monopolist on a market or whether there is competition from substitute products which would prevent this. However, we are not clear that the conclusions arrived at are necessarily appropriate, or that their implications are consistently applied.

First, consider the potential for the forward market to encompass both electricity derivative hedges and fuel / carbon hedges, as suggested in the consultation paper. Fuel and/or carbon hedges are imperfect. In other words, for a given electricity position (e.g. a short position as a result of a customer base), hedging using fuel contracts (e.g. buying gas forward) will not remove all value at risk resulting from market price volatility in the same way that buying a forward electricity contract would. This is because there is a less than perfect correlation between fuel and electricity prices.

As a result, the market can be narrowed further from this definition. A hypothetical monopolist over forward electricity contracts would be able to profitably increase the prices of their hedges above the competitive level. The magnitude of the price increase possible will depend on the correlation between power and gas prices. The lower the correlation, the less good a substitute a fuel hedge would be, and the higher the profitable price rise possible. The SEM Committee does not appear to undertake any quantitative analysis to assess this. Based on our experience, we believe such analysis would conclude that fuel hedges are not part of the relevant market.

Second, consider different products within the electricity forward market. Faced with a domestic customer base, a mix of forward products may be needed to achieve a complete hedge. In the same way as fuel hedges, buying one product type (e.g. base load electricity hedges) may result in some ongoing exposure to market price risk. Therefore, a hypothetical monopolist over, say, mid merit or peak hedge products might be able to sustain a profitable price increase, and therefore abuse a position of dominance, because those demanding hedges might be willing to pay more for a more complete hedge (rather than substituting away towards a base load hedge, for example).

We would therefore suggest that the SEM Committee (a) defines a relevant market for forward products which at least excludes non-electricity hedging products, and (b) considers the possibility that the relevant market(s) may actually be for specific electricity forward products (i.e. baseload, mid-merit 1&2 and peak) rather than there being one overall relevant market.

Further we note that even given the market identified by the SEM Committee in its document, there is some logical inconsistency in the way it is applied. For example, the document suggests that the physical spot markets can act as a discipline on pricing in the forward markets. Having (appropriately, in our view) identified forward and physical markets as separate relevant markets from a competition viewpoint, by definition one cannot be a substitute and therefore exert significant competitive discipline on the other.

Based on this framework, we believe it is possible to draw two conclusions of relevance for the SEM Committee's analysis. First, analysis of the effectiveness of competition and the barriers to entry should be considered relative to the market definitions discussed above. Secondly, mitigation options to counter market power should differentiate between forward product types, just as directed contracts are provided across a range of product types, and just as GB market making provisions apply to a range of different product types.

3. *Do you agree with the proposed geographic scope of the proposed markets/trading periods?*

In its [1997 Notice](#)<sup>2</sup> relating to the ‘definition of relevant market’, the European Commission defines the relevant geographic market as “the area in which the firms concerned are involved in the supply of products or services and in which the conditions of competition are sufficiently homogenous”. In terms of analysing this, the Commission Notice refers to an assessment of the obstacles faced by a supplier or consumer in providing or accessing (respectively) a good or service on a given market. This is traditionally quantified by reference to the ‘Small but Significant Non-Transitory Increase in Price’ (SSNIP) Test (typically between 5% -10%).

With respect to defining the geographic market for the electricity market, the SSNIP test can be applied to each of the markets and each of the market timeframes. Focusing solely on the physical markets of the day-ahead, intra-day and balancing markets for now, BGE is of the view that the geographic markets are as follows:

- The Day-Ahead and Intra-Day markets consist of an **all-island market**. This is based on an assumption that the market rules will be ‘unconstrained’ in the same way as it is in the existing SEM market<sup>3</sup>.
- The Balancing Market’s geographic scope may be more dynamic and may change considerably depending on TSO operational decisions and wind output. As a starting point, the Balancing Market’s geographic scope will be the all-island market, but as operational and physical system constraints bind, the geographical market may diminish and become more localised.

BGE agrees with the SEM Committee’s assertion that the GB market is not part of the relevant geographic market for the purposes of defining the relevant market and assessing market power in the ISEM. Although we recognise that the construction of EWIC has increased the level of interconnection with GB, a high level application of the SSNIP test clearly proves that the market rules and access are not sufficiently homogenous to consider these part of a single geographic market;

- Firstly, the physical limitation of interconnector capacity limits the ability of GB generators to switch production and sell power in the Irish market and/or the ability of Irish suppliers to purchase power in the GB market in response to a small but significant price increase.
- Secondly, the deadband between GB and SEM prices, although falling, has been traditionally high (greater than the SSNIP threshold of 5%-10%) as a result of the difference in market timeframes, the cost of interconnector capacity and the difference in market rules between the two markets. Although ISEM should remove the deadband related to inefficient trading, a deadband will still exist reflecting the inevitable congestion between the two markets.

For these reasons, BGE believes there is good rationale and evidence to support the SEM Committee’s proposal to limit the geographic scope of the ISEM to the all-island market in the Day-Ahead, Intra-Day, and Balancing Markets as a starting point. Depending on market rules relating to physical constraints, the scope may be reduced further to reflect local market power.

#### **Section 4: ISEM Design, Interactions and Implications**

4. *Do you agree with the proposed definition of competitive behaviour and pricing in ISEM?*

Section 4.2 of the consultation paper defines competitive behavior as “Competitive offers equal to short run marginal cost (SRMC), where SRMC includes relevant opportunity costs”. This definition is very narrow and must be considered in the round of the various energy markets (capacity, ancillary and physical energy), market timeframes (forward, day-ahead, intra-day and balancing markets) and dynamic bidding that will inevitably persist in ISEM.

To the extent that it is envisaged that the ISEM will include a capacity market as a means of enabling parties to recover their fixed or long-run costs, it may be fair to assume that parties will recover their variable or short run costs through the ancillary and physical energy markets. However, this assumption

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<sup>2</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=URISERV:l26073&from=EN>

<sup>3</sup> There may be some hours where this is not the case, but this is likely to be very marginal.

is predicated on the fact that the capacity market purchases sufficient capacity to account for normal energy demand and sufficient reserves to meet exceptional demand and/or supply scenarios. This in turn will require an efficient secondary capacity market to enable those parties who do not receive an initial capacity contract, but who are still required to meet system requirements, to recover their fixed costs. In the event that the capacity market does not provide for sufficient reserve (that is reserve above the typical margin that a TSO requires on a day to day basis to cover outages, trips and changes in demand/supply forecasts), certain parties may be required to bid into the energy market above their SRMC level to recover their legitimate costs.

In addition to the capacity market, an assessment of competitive behavior must also consider the interactions of the ancillary service and energy markets. Defining and assessing SRMC bidding behavior will therefore need to be more dynamic than it is currently in the SEM. That is, bidding assessments will need to account for opportunity costs and revenues across the two markets simultaneously and allow for parties to reflect the marginal costs and risk associated with each accordingly. Similarly, SRMC bidding behavior may also have to account for risks associated with exposures to paybacks under the Reliability Option element of the capacity market.

5. *Do you think that the suggested examples in which market power can be exercised in I-SEM captures the relevant issues?*

We consider the examples presented capture some of the main ways that market power could be exercised in I-SEM, namely:

- Withholding to increase prices, and thereby earning monopoly rents;
- Predation to foreclose rivals, with the intention of recouping lost profits in the future; and
- Bidding to heighten transmission constraints, thereby earning monopoly rents in some locations.

However, these examples do not capture the potential for participants with market power to raise rivals' costs, thereby potentially (partially) foreclosing competition in the supply market, leading to higher prices and consumer harm. In our view, such strategies are more likely than predation as the participant exercising market power would not have to sustain losses in the short-term.

For example, a vertically integrated competitor with market power may withhold from forward markets to increase hedging costs of competitors (for any given expected spot price level). Such withholding could be partial, or at certain times the competitor may completely withdraw supply of certain products. Such a strategy could increase the costs of hedging to competitors (a margin squeeze), damaging competition in the supply market, and eventually allowing the vertically integrated competitor to increase prices to its own end-consumers. The overall outcome would be high retail electricity prices and significant consumer harm.

We note in this regard that the regulator will, going forward, be in receipt of information in relation to segmental margins by retailer. An important use to which this information could be put would be monitoring the possibility that upstream market power is being exerted through a downstream margin squeeze on competitors. While such analysis is necessarily complex and will involve consideration of a range of different factors which could influence retail margins, we believe this is as critical a consideration in relation to effective competition in the market as excessive pricing. It is likely that such analysis is only needed for those parties holding positions of dominance across the two markets.

6. *Do you agree that the potential for market power abuse in I-SEM appears to be weaker in the forward financial market compared to the physical markets?*

Absent any regulatory intervention, the potential for market power abuse in I-SEM may well be stronger in the physical market compared to the financial market. However, we do not consider this to be a relevant question when considering market power mitigation remedies. That is because the regulatory structure of I-SEM should seek to ensure that outcomes similar to competitive markets are likely in all relevant markets.

For example, imagine a situation where, absent intervention, the existence of market power in physical markets led to prices 10% above competitive levels, and the existence of market power in forward markets led to prices 5% above competitive levels (and hence to higher prices for retailers forced to purchase these hedges and weaker competition for integrated retailers which do not). In our view, the fact that market power was being exercised in both markets should be a cause for concern. The relative difference in the exercise of market power should not be determinative in the design of market power mitigation options.

In any case, the conclusion that market power is weaker in the forward market seems to be based on a number of tenuous assumptions. The assumptions relating to the elasticity of demand in the forward market, the role of European financial regulations and the substitutability of products within the forward market are in our view overly simplistic and have not been appropriately tested against real market evidence.

We consider that there is evidence to suggest that there is the potential for the exercise of market power in forward markets in I-SEM which needs to be addressed with sector specific intervention. This is based on five factors:

1. Separate forward and physical markets have been defined for I-SEM, which suggests there is limited demand-side substitutability between forward market and physical market products.
2. The forward market in SEM has exhibited persistently high levels of supply-side concentration.
3. The conditions of entry suggest that entry or expansion by existing competitors is not likely to be sufficient in extent or in a timely fashion to constrain the exercise of market power.
4. Evidence from SEM forward markets is consistent with the exercise of market power.
5. Financial regulation will not provide for appropriate mitigation of market power in forward markets

These points are expanded upon below.

### **Separate forward markets**

The SEM Committee in its market power consultation paper has identified that forward products are sufficiently different to the various physical products, such that they constitute a separate market. As we argue above, by defining the forward market separately to the physical markets, the SEM Committee has recognised that the degree of competitive constraint from other products (i.e. physical energy products) is insufficient to constrain the exercise of market power in the forward market.

### **Concentrated market**

The SEM committee has not provided market share or concentration measures for the forward markets. However, it has stated that there are only three firms that regularly supply into this market. The ability of these firms to supply specific forward products may be limited, because their physical position may only match to some products. For example, baseload generators will be better placed to offer baseload hedges – offering only mid-merit or peak hedges would leave them with some market price volatility unhedged. This means that market power issues in relation to some products may be even more marked. From our experience, ESB have accounted for the majority of sales in this market throughout SEM and across all product types.

This suggests that the forward market in SEM is highly concentrated, raising the prospect of persistent market power. Absent entry or regulatory intervention, it could be expected that such high levels of concentration would persist in I-SEM.

### **Conditions of entry**

For entry to constrain market power, it must be sufficiently likely, of sufficient extent and occur in a timely fashion. Given that the forward market has historically remained concentrated, we consider that the SEM Committee requires robust evidence that entry will likely constrain market power in the forward market before it dismisses the potential for the exercise of market power.

The likelihood of entry depends on expected profitability of the entrant, which in turn relies on the costs and risks associated with entry and expansion. We have identified three key factors, in addition to those

highlighted in the consultation document, that we consider makes entry into the forward market unlikely:

- **Lack of liquidity:** It is recognised that a lack of market liquidity can act as a barrier to entry and expansion (in just the same way as liquidity itself can lead to further liquidity).<sup>4</sup> In forward electricity markets, entrants would face a risk if the market is perceived to be ‘thin’, as it may be difficult for them to readily unwind open positions without the risk of a significant price movement.<sup>5</sup> The risk associated with a lack of liquidity is amplified by the below three factors.
- **Level of despatch risk:** Even in a thin market, players with physical assets may be willing to expand their offers of forward hedges (to the level of their physical capacity) if they can predict readily when they will be despatched. This is because their physical position will offset their forward sales. However, despatch risk is greater in small markets such as the SEM, in markets where parties frequently hold single plants, and in markets where there is a party with a dominant position in spot markets.
- **Information asymmetry:** It is widely recognised that market power can be exercised through informational advantages that a large incumbent may possess. In this case, an incumbent such as ESB would be likely to have an informational advantage over an entrant (particularly a non-physical player) in the forward market in relation to the formation of prices in the physical market (on which forward prices depend). This would increase an entrant’s risk and cost, thereby making entry less likely.
- **Exclusionary response:** The ability of an incumbent to respond strategically to an entrant can be a decisive factor in relation to the likelihood of entry. The fact that ESB maintains such a large generation portfolio would increase the risk (perceived and actual) to an entrant that ESB could strategically respond, for example by manipulating the reference price to which forward contracts are set, thereby exacerbating the risk an entrant may face from any long or short position.

We note that the GB forwards market has suffered from a lack of liquidity and a perception that the cost of hedges to (particularly smaller) suppliers is high. This is despite the GB physical market being significantly less concentrated, and the GB forward market being larger and hence ostensibly more attractive to entrants than SEM/ISEM. The exit of financial players followed by the ongoing lack of re-entry and resulting lack of liquidity in GB led to the need for regulatory intervention in the form of the market maker provisions.

We consider that the fact that there has been little entry or expansion in the forward market in SEM, combined with evidence of persistent lack of liquidity in larger markets such as GB, is evidence that entry should not be heavily relied upon to prevent the exercise of market power in the forward market.

### **Evidence consistent with the exercise of market power**

It is important to consider what the exercise of market power in forward markets looks like. It is clear that pricing up of hedge products to make downstream entry less profitable would constitute exercise of market power. But this is not the only route which would be open to them. Indeed, since it would be one of the more detectable approaches, it is perhaps one of the less likely strategies to be observed.

As we outlined previously in our response to the Market Power Discussion Paper, price and volume volatility can be applied as strategies to discourage entry/expansion or make exit of downstream players more likely.

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<sup>4</sup> See for example, CEPA, “Market Power and Liquidity in SEM: A report for the CER and the Utility Regulation”.

<sup>5</sup> We note that the I-SEM market power workstream is closely related to the liquidity workstream. We also note that liquidity issues may arise for a number of reasons, irrespective of the presence or not of market power. However, this does not obviate the fact that a lack of liquidity will reduce the likelihood of entry, thereby increasing the potential to exercise market power.

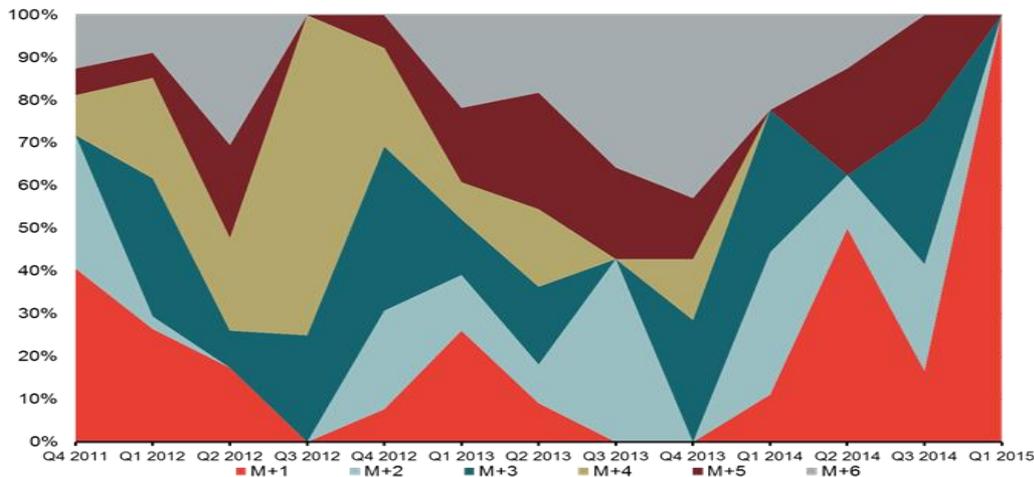
Parties participate in forward hedging markets to reduce their price risk. If they are confident as to their ability to strike hedging contracts at any given time and price they will perceive lower risk and will be more likely to enter / expand their downstream position. In contrast, volatility in either forward product pricing or availability will tend to dissuade retail entry or growth. This is because it will make non-integrated and short retailers consider the possibility of being imperfectly hedged<sup>6</sup> (because of the possible unavailability of a relevant product for a period) or of facing higher hedging prices if they are forced to hedge at specific times.

In assessing observed behaviour in SEM forward markets, the SEM Committee should therefore not focus on price alone. It is important that excessive volatility in product availability and pricing is also interpreted as being consistent with the exercise of market power. If excessive volatility is present, it will tend to reduce the degree to which non-integrated retailers pursue market share growth, and hence damage competition to the detriment of customers.

Given this, we consider there is evidence consistent with the exercise of market power in the forward markets in SEM.

There is currently extreme volatility in product availability in SEM. Figure 1 shows the percentage of traded NDCs across the market by time to delivery (for baseload only). Figure 2 shows the comparison for GB, which has much less volatility. It is clear from the figures that there is extreme volatility in the availability of forward products in SEM. This evidence of extreme volatility in the proportions of NDC products traded is consistent with participants withholding products from the market to raise rivals' costs.

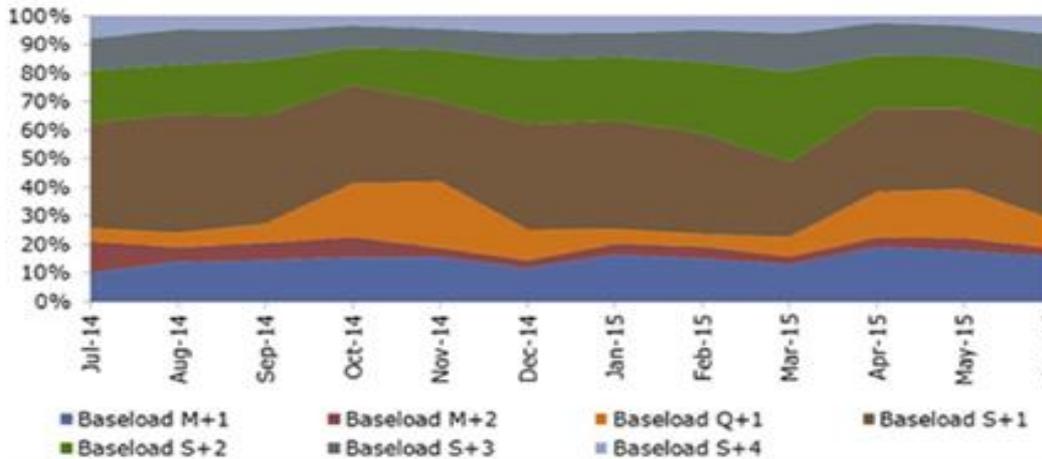
Figure 1. Quarterly proportion of SEM NDCs monthly products by time to delivery



Source: NDC traded data as reported by Tullett Prebon

<sup>6</sup> We note that as imperfect hedging implies potential imbalance exposure, in a market with significant levels of market power in the balancing mechanism the implications of uncertain hedge product availability may be magnified.

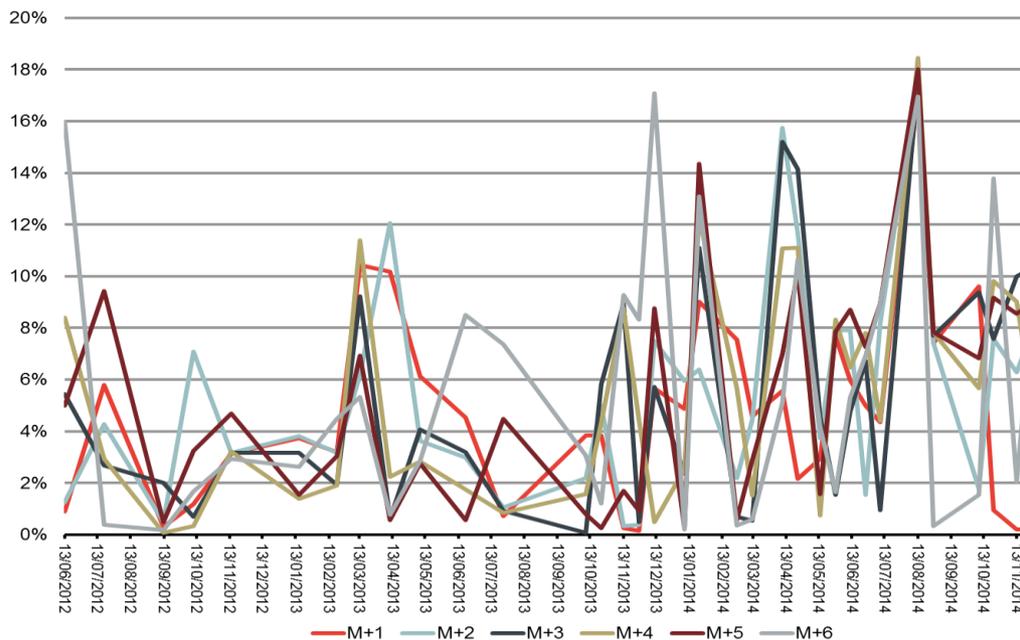
Figure 2. Quarterly proportion of GB forward products by time to delivery



Source: Ofgem, Wholesale Power Market Liquidity: Annual Report 2015

Forward market spreads in SEM are also extremely volatile. Figure 3 shows spreads over time for baseload NDCs in SEM. It is worth noting that the spreads shown are both high (on average) and extremely volatile.

Figure 3. Spreads over time for SEM baseload NDCs

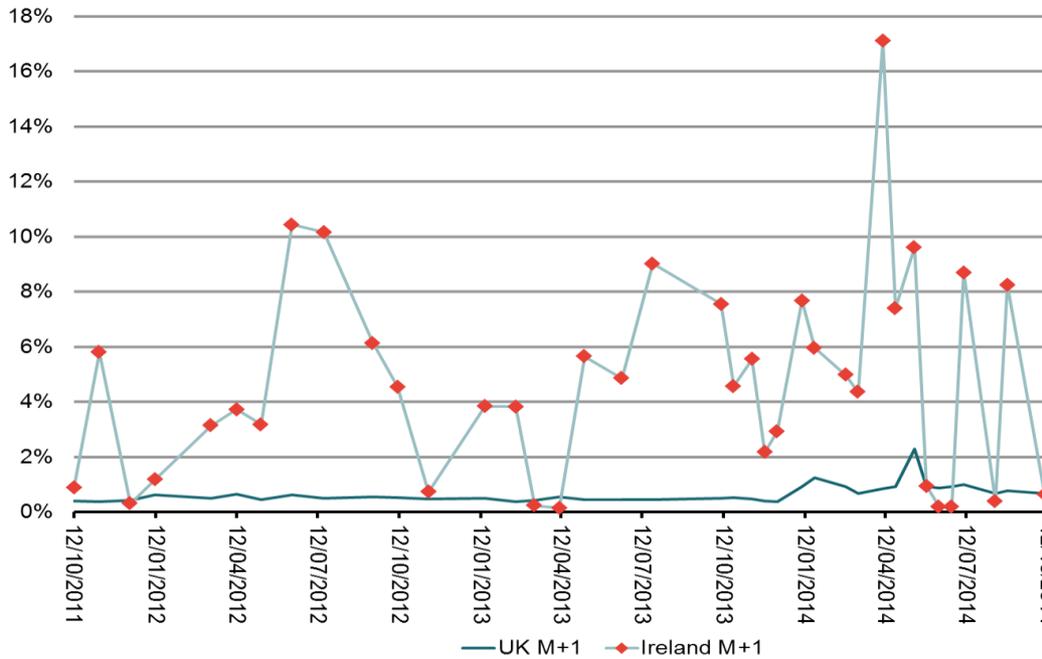


Source: NDC traded data as reported by Tullett Prebon

We have also compared SEM spreads with spreads for similar products in GB. Figure 4 compares spreads for baseload M+1 for SEM and GB. Similar results are found for other products. We note that the graph includes a time period prior to the implementation of market making obligations in GB. That is, it includes GB data for a time period when the regulator considered there to be significant liquidity issues in the forward market. Even in these periods the SEM outcomes look more volatile. Therefore, one could reasonably conclude that there is some additional factor driving the incremental volatility in

spreads in SEM. This evidence is consistent with participants withholding products from the market and in so doing raising rivals' costs.

**Figure 4.** GB versus Ireland spreads for baseload M+1



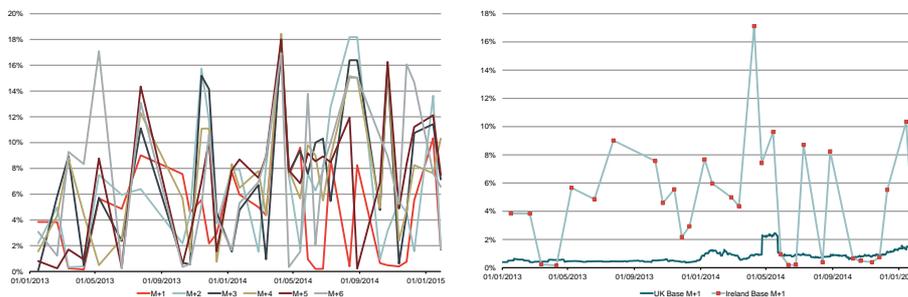
Source: Bloomberg; NDC traded data as reported by Tullett Prebon<sup>7</sup>

We understand the suggestion that the spread between GB and SEM forward contract prices may have reduced over the past two years. As we note above, even if this were true we do not believe it is consistent with an argument that market power is not being exercised or is declining, if excessive volatility of pricing remains.

We present below data for the past two years (starting on 1 January 2013). It is clear that spreads in SEM have still shown very high volatility and that, compared to the GB market, spreads have been on average higher. The average difference between GB and SEM spreads does not vary significantly (3.7% in 2013 compared to 3.6% in 2014) and the volatility of SEM spreads if anything increased in 2014 (with SEM spreads showing a standard deviation over mean of 1.23 in 2014 compared to 0.71 in 2013).

<sup>7</sup> Note: We have used a five week rolling average for GB as SEM OTC trading occurs approximately every five weeks. Recent upturn in GB spread data is due to Bloomberg reporting end-of day spreads, however most volumes are now concentrated in regulated windows (i.e. where there is lower spreads)

**Figure 5. Spread data: zoom on last two years**



Source: Bloomberg; NDC trading data as reported by Tullett Prebon

### Impact of financial regulation

The SEM Committee suggests that there is the potential for ongoing EU regulatory developments such as EMIR and MiFiD to address market power issues in forward markets.

It is true that these developments, given their scope, should increase the transparency of behaviour in forward markets. However, increased transparency and information availability will at best facilitate *ex post* analysis of situations where there is a belief that market power *has been exercised*. EU regulations will not play a significant role in preventing the exercise of that market power in the first place. This is unsurprising since they have been designed to be applied across a wide range of markets with very different potentials for the exercise of market power. Sector specific regulation should therefore be considered to mitigate the risks which are clearly demonstrated by the analysis above.

### Summary

On the basis of the above, we consider that there is evidence consistent with the exercise of market power in the SEM forward markets, and reason to believe that this will not be addressed by competitive dynamics such as new entry going into ISEM. The implications of the exercise of market power in forward markets have direct customer impacts. First, retailers required to trade in the forward market will have higher costs. They will therefore be less able to offer competitive/low prices to customers. Second, integrated portfolio players will face less competition over time (e.g. if non-integrated players exit) which may eventually allow them to raise prices to customers to a greater extent than would have otherwise been the case.

We note that the liquidity workstream may resolve some of these issues, depending on the remedies put in place. However, we consider it is incumbent on the SEM Committee to consider the forward market in full, as the current consultation paper dismisses these concerns too readily without a full analysis of market power metrics, estimating or modelling outcomes in this market, reviewing current mitigation measures against these concerns, or considering potential mitigation options for ISEM.

7. *Do you agree with the implications for market power arising from interactions between the physical markets, CRM, FTRs and DS3 System Services as shown above?*

#### 7.1 Interactions between the CRM and Physical Energy Market

The reliability option aspect of the CRM creates a direct link between the physical energy market and the capacity market and in so doing, provides a party with market power in the physical energy market an opportunity to exercise market power in the CRM. Given that a party holding a capacity contract will be exposed to a payback under the reliability option where the market reference price<sup>8</sup> goes above the strike price, a party that can exercise market power and influence prices in the reference market(s) will

<sup>8</sup> As per the SEM Committee’s latest CRM Decision Paper, SEM/15/103, the reference market will be both the day-ahead market and the balancing market.

by association be able to influence the risk exposure to difference payments of other parties who hold capacity contracts. These other parties would factor in this risk to the Reliability Option auction, the impact of which could be to either exclude or push parties out of the capacity market and/or increase capacity prices.

We therefore suggest that when assessing incentives and effects for exercising market power in the physical market and the necessary mitigation measures, the analysis should also consider the impact on and interactions with the capacity market.

Related to this, as the reliability option exposes parties to revenue paybacks when the reference price goes above the strike price, this should be considered as a legitimate risk and therefore opportunity cost within the context of the ISEM. This opportunity cost should also be accounted for when considering ‘competitive behaviour’ as discussed in Section 4 above and Section 8 below.

### 7.2 Interactions between Financial Transmission Rights and the Physical Energy Market

Section 4.6.2 of the consultation paper recognises that a party holding a Financial Transmission Right on an interconnector would have an incentive to manipulate prices in either the GB or SEM markets. BGE would therefore question whether a party that is deemed to hold significant market power and can thus influence market prices in the SEM should be permitted to hold FTRs?

### 7.3 Interactions between the Ancillary Service Market (DS3) and the Physical Energy Market

We agree with the SEM Committee’s assertion that the outcome of the ancillary service market auctions may create specific local markets, which may drive local market power within the energy market. In addition to that and as noted in Section 4 above, we believe there is a clear and inter-dependent link between the ancillary service and how a party will bid in the physical energy market.

Considering that the provision of ancillary services will largely require a unit to be synchronized to the grid and therefore running in the energy market, and that there will be a direct trade-off between the volume of energy sold and the volume of certain ancillary services provided (for ramping and reserve product namely), the final design and operation of the ancillary service market will have implications for the assessment and determination of ‘competitive behaviour’ in the ISEM. Depending on the final design of the auction, tariff, contract and penalty provisions for the ancillary service market, this will have implications for the opportunity costs of ancillary service contract holders in the energy market.

## **Section 5: Relevant ISEM Metrics**

### *8. Do you agree that these are the appropriate metrics to identify market power ex-ante and ex-post in I-SEM?*

In line with the Structure Conduct Performance framework, BGE agrees with the SEM Committee’s ex-ante and ex-post approach to assessing and monitoring market power in the ISEM. An ex-ante approach, which incorporates market shares (by capacity and market schedule), market concentration (using the HHI) and market dynamics (using the RSI), will give useful and critical insight into the structure of the market and the extent to which market power is embedded in the market. This in turn will inform the level of investment that will be needed in preventing and monitoring market power.

Using bidding, availability, pricing and cost information to conduct ex-post analysis of market outcomes will also be useful in ensuring that any exercise of market power, even if transient, is detected. A robust and transparent ex-post process will complement a Mitigation Strategy (which is discussed further in Section 8 below) by providing continuous and rigorous market monitoring, thereby dis-incentivising abuses of market power.

Lastly, an assessment of long-term market liquidity will be a good performance indicator of the market and will be a very important metric of competitive dynamics in both the wholesale and retail markets. As outlined in answer to Q6 above, we believe that liquidity, measured in terms of volumes, prices and volatility, will be key metrics in understanding the level of market power (and the exercise of this market power) in the forwards market.

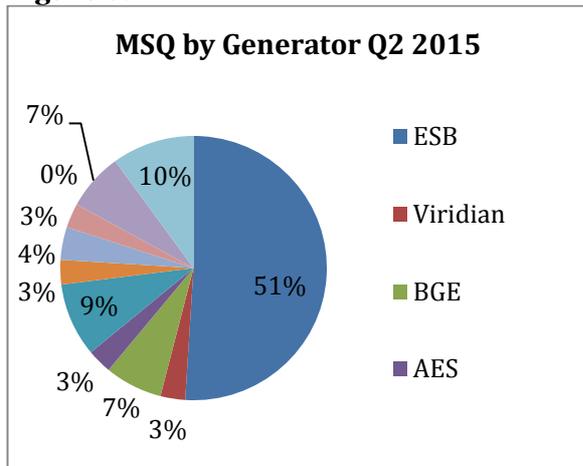
Reference is made to using net revenues as a measure of market performance, however, as noted in the Consultation Paper, this may be difficult to derive practically, can be mis-interpreted if not assessed over a reasonable timeframe and has been used erroneously in other markets. This in turn has led to under-investment and capacity shortage in these markets.

9. *Are there other metrics that you consider should be applied?*

Although we recognise that this is an ISEM and therefore wholesale market consultation, we do not think that it should discount the retail market. A party with a strong position in the retail market, i.e. a dominant buyer, has the ability to influence contracts, prices and investments in the wholesale market. Of even more concern is the fact that a vertically integrated party with a dominant position in both the wholesale and the retail market has both the ability and incentive to influence wholesale prices and foreclose the wholesale market to both upstream and downstream competitors.

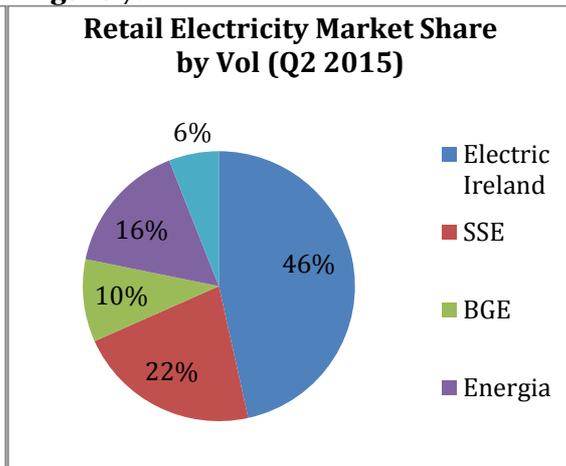
Specifically, a dominant vertically integrated party can limit liquidity to independent generators by restricting demand and can limit liquidity to independent supplier by restricting supply. It is clear from the most recent market information as outlined in figures 6 & 7 below, that ESB holds a dominant position in both the retail and wholesale markets (please note that ESB's market share in the retail market is 60% when assessed with reference to customer numbers). Although there is a level of ring-fencing between their generation and retail businesses, the former ESBI and ESBIE business units remain vertically integrated. Furthermore, and as we will discuss in further detail in Section 8 below, the ring-fencing provisions are meaningless in the forward market where contracts are struck on a financial basis and the two contracting parties have consolidated financial accounts.

**Figure 6:**



Source: SEM/15/072

**Figure 7:**



Source: CER/15/281

In short, we believe that the level of retail margins should be a focus point for the regulators when monitoring ex-post behaviour, and in particular, to assess whether market power in the generation sector is being exercised via a downstream margin squeeze. This would be apparent through persistently low margins for the incumbent integrated retail business. While we return to the issue in Section 8 below, we are strongly of the view that no extent of ring-fencing can remove the incentive to undertake a margin squeeze. This is because ring-fencing cannot remove the fact that the profits of an integrated retail and generation business are in the end consolidated within a set of Group financial accounts.

Lastly, the definition of metrics is only meaningful if they are routinely monitored in an effective way (which has resourcing implications for the MMU) and if there are meaningful sanctions for behaviour contravening the market principles/competitive expectations. A regime in which the only sanction is ex-post correction for future behaviour is insufficient in BGE's view.

## **Section 6: Estimate of ISEM Market Power**

*10. Do you agree with the approach taken by the RAs to modelling market power in I-SEM?*

Modelling by its nature is not an exact science and therefore there are always limitations to any modelling exercise. That is not to say that the modelling exercise outlined in section 6 of the Consultation Paper is futile – the aim is to provide a simplified simulation of market dynamics and to understand within the context of this simplified model if market power is a problem and can be exercised.

In its ongoing investigation of the energy market in the UK, the Competition and Markets Authority recognise this limitation but continue by saying “[simplifications] limit the ability to strongly rely on positive results, and therefore will require further investigation and processing. However, if harm cannot be found in the simple model, we can almost certainly rule out there being harm in the more complex model which better reflects the real world”<sup>9</sup>. Within the context of the ISEM modelling exercise, although the modelling exercise undertaken by the SEM Committee may be a simplification of the real world under ISEM, it is clear that there is potential for market power to be exercised and it is incumbent on the SEM Committee to investigate this risk further and implement a mitigation strategy to prevent, monitor and address market power in ISEM.

In terms of the specifics of the modelling exercise, whereby we agree with the principles followed, the objectives and the conclusions given the information we have seen, we have not seen the full details of the modelling itself and therefore cannot comment on the output specifically.

*11. Do you agree with the conclusions for I-SEM market power that have been drawn from the modelling results?*

The results from the SEM Committee’s modelling are very interesting and insightful. Particularly the contrasting evidence from the HHI and RSI measures, which reinforces a point BGE made in its previous response to the SEM Committee’s Market Power Discussion Paper relating to price volatility as a form of market power abuse. The results also confirm BGE’s concern that both the time and locational critical aspect of the balancing market makes it susceptible to abuses of market power. As a supplier, concerned about forward market liquidity and with peaky residential demand, the risk related to ISEM and specifically balancing responsibility increases further relative to now.

## **Section 7: Review of Current SEM Measures**

*12. Do you agree with the SEM Committee’s view on the effectiveness of each of the SEM market power mitigation measures?*

As outlined in our response to the previous Discussion Paper on Market Power, BGE is of the view that relative to the previous wholesale market design pre-SEM, the SEM has provided transparent pricing and a liquid spot market, which have in turn contributed to greater levels of competition. In so doing, the SEM market power mitigation strategy has been effective in ensuring that the spot market price is on average cost reflective. The Bidding Code of Practice, coupled with the MMU and the provision of directed contracts has been effective in this regard.

BGE is not convinced however that the ring-fencing provisions for the ESB Group have been effective. From a physical market perspective, as all power must be bought and sold in the day-ahead market at a single clearing price in accordance with the BCOP, the effect of the arrangements are dampened. In reality, it is the BCOP, Directed Contracts and the MMU that prevent market power from being exercised by vertically integrated and dominant parties in the physical energy market.

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<sup>9</sup> <https://assets.digital.cabinet-office.gov.uk/media/559fb549e5274a155c000044/Appendix 4.1 Market power in generation.pdf>

With reference to the forwards market, as this is solely a financial market and ESB Power Generation and Electric Ireland are part of the same consolidated Group financial accounts, the arms length arrangements are ineffective. As a vertically integrated but long generator and the dominant party in the forward market (by virtue of its legacy assets and market scheduling certainty), ESB has the ability and incentive to price up forward prices to retailers. Even though its retail business will pay this higher price, the Group will still be more profitable on a consolidated basis. The existence of ring-fencing does not change this incentive and in our view is a considerable factor in the limited forward market liquidity we have witnessed in the SEM to-date. This point is discussed further in Section 8 below under the specific ring-fencing questions posed in the Consultation.

*13. Are there any particular aspects of the SEM market power mitigation strategy that you think should be applied differently, especially in relation to I-SEM?*

As will be discussed in more detail in Section 8 below (answers to questions 16 & 17), BGE is in favour of a form of bidding principles being applied to the physical energy markets (being the day-ahead, intra-day and balancing market), albeit on a less restrictive basis than current BCOP bidding, more in line with a “competitive bidding” rationale. These bidding principles as well as the dynamic market power assessment process outlined in Section 6 of the Consultation Paper will require a more heavily resourced MMU. The market is moving to continuous trading and participants will react accordingly. The MMU will need to match this intensity if the Market Power Mitigation Strategy is to be successful and the market outcomes competitive. Given the demands on the SEM Committee’s already limited resources, it may be worth considering whether the day-to-day operations of the new enhanced MMU role would be better fulfilled by an external agent on behalf of the SEM Committee.

It is also critical that the MMU is given the necessary power to take commensurate action for those found in breach of market power controls. The current provision, which we believe only allows the MMU to direct changes to bids, will not be effective in deterring anti-competitive behavior.

Also, given our views on forward market power, we believe the SEM Committee needs to take a more active role in driving greater forward market liquidity and monitoring how a vertically integrated entity (even if ring-fenced) can use its upstream and downstream positions to exercise market power in this market.

## **Section 8: SEM Mitigation Strategy & Measures**

*14. Do you agree with the five key principles for assessing market power mitigation policies as outlined in this section 8.3? If you think there should be alternatives, please state the reasoning.*

The principles of; 1) effective; 2) targeted; 3) flexible; 4) practical, and 5) transparent are each reasonable principles at a high level for a Market Power Mitigation Strategy. Within the context of each of these principles, BGE believes a reasonable Strategy can be delivered which is sufficiently pro-active to avoid customer harm resulting from transient abuses of market power, yet sufficiently targeted and tailored such that it does not dampen natural competitive dynamics between those parties in the market who do not hold market power.

These principles will work alongside the market metrics outlined in Section 6 to provide a reasonable and detailed quantitative and qualitative assessment of the impact an exercise of market power may have on the market, and the trade-off for the market of the different mitigation options.

*15. For the Forward Contracting Obligation:*

- a. What should be the measure and threshold that results in a market participant being included or excluded in the FCO, i.e. what is its applicability? - What should be the volume and product definition of forward contracting required from a market*

*participant who falls under the FCO? - How should the price be set for the volume contracted under the FCO? - What type of access should buyers have to FCO volumes?*

The consultation document suggests that the options for pricing of FCOs are:

- To allow the obligated party to set the price, with the requirement being to sell a required forecast volume;
- An administered price; or
- A combination of the above.

A market-based price has obvious appeal from an efficiency perspective. However, we have identified two major issues which we consider would need to be addressed before such a system could be implemented:

- **Sufficient volumes:** The price of FCOs will be a function of the obligated volumes. If participants with market power are not required to supply sufficient volumes, then the FCOs will be bid up towards the monopoly price, and will render them ineffective.
- **Exclusion of participants with market power:** Clearly if prices are set by the obligated party, they should in no way be able to participate on the buyer side for FCOs. If they were permitted to buy FCOs, they would have the incentive to bid up the price, as this would foreclose competitors from the ability to access this product, thereby raising rivals' costs. The obligated party would have the knowledge that in contrast to rivals, from a group perspective it would be indifferent to high prices (if it bid up the price, the value would be kept within the same organisation, and therefore at a group level it would be no worse off).

We consider ring-fencing in more detail below, and set out what it is feasible for ring-fencing to achieve and what it will not be able to do. In the context of FCOs, it is important to note that the ring-fencing or vertical separation measures will not change the incentives on such buyer side behaviour. Even within a ring-fenced part of a corporate group, decision makers will be aware of the impact of the activities of their business units on wider group performance (this cannot be impacted by ring-fencing). This has been clearly acknowledged in other contexts, including by the European Commission which, as part of the Third Energy Package, set out ring-fencing requirements on TSOs and supplemented them with an extremely onerous governance and compliance regime in what they acknowledged was still an inferior model to ownership unbundling in terms of ensuring independence of decision making.

If these conditions are not met, then a market based approach to the pricing and allocation of FCOs would be ineffective. In this situation, we would therefore support a more administered approach, as is currently used for Directed Contracts, with price being determined by the regulatory authorities and with allocation being on the basis of a pre-define rule. Indeed, given the timelines for implementation, this may be the best initial approach for ISEM Go-Live.

- *What type of access should buyers have to FCO volumes?*

The consultation paper suggest that buyer access could be determined:

- by a market mechanism (e.g. an auction); or
- administratively.

Again, we note that if a market-based mechanism is to be used, then an obligated party should not be able to participate on the buyer side. This is because the obligated party would have the incentive to bid up the price of FCOs, as this would foreclose competitors from the ability to access this product, thereby raising their costs. The obligated party would also have the knowledge that if it bid up the price, the value would be kept within the same organisation, and it would be no worse off.

In setting the access to FCO volumes administratively, the SEM Committee should also consider other means of determining eligibility other than simply using retail market share. This methodology in BGE's view perpetuates the problem of barriers to market entry and expansion for smaller players and enhances the competitive position of the dominant incumbent retailer. It seems counter-intuitive to the

overall aim of competitive markets that the dominant generator sells the majority of its FCO volumes to the dominant incumbent supplier. Would competition and indeed liquidity not be better enhanced if both dominant incumbents were forced to trade with other independent parties?

- *What should the volume and product definition be?*

It may be that a combination of the HHI (for the day-ahead market and the RSI (for the intra-day and balancing markets) is used to understand the dynamics of competition. In setting the volume threshold for the FCO, the HHI metric alone is likely not suitable for the ISEM as it is only calculated at a single point in time for a point in time. The SEM Committee's analysis clearly shows that the HHI will not identify those *timeframes* when market power will be at its highest. On that basis, the RSI should be used to identify dynamic market power, particularly as it changes in the intra-day and the balancing markets.

When calculating the HHI, we believe that it should be adjusted to account for wind. As wind is not predictable and therefore is not instructive for the purposes of understanding market power and the ability and incentive to use market power in the energy markets, we believe that wind should be netted from the HHI calculation

As outlined in answer to question 6 above, BGE believes there may be merit in breaking down the FCO into baseload, mid-merit and peak products and offering products to the market accordingly. However, further analysis on the impact this would have on the overall volumes offered, and therefore the ability and incentive to exercise market power in the physical markets, should be conducted before a decision is made.

The same is true for how the FCO volume threshold is set in the market. BGE would welcome further analysis on the outcome of different thresholds before a decision is made. When considering the relevant threshold, BGE is drawn to Section 6.6.9 of the consultation, which makes reference to the fact that parties who do not hold structural market power may also be in a position to exercise market power. Whereby we understand the potential that has been identified by the SEM Committee's modelling results, when considering a threshold for the application of the FCO or any market power mitigation strategy, we must also consider whether the party identified as having structural or ad hoc market power has the *ability* to influence and/or predict when they will have market power **and** also the *incentive* to exercise this market power.

This point is relevant both in terms of considering the metrics used by the SEM Committee in assessing market power and setting thresholds, specifically the need to consider the retail market within the context of assessing the incentive to exercise market power in the wholesale market (as outlined in answer to question 9 in Section 5 above), and in the context of designing mitigation measures that are fit for purpose and effective (as discussed in more detail in answering questions 16 and 17 below).

16. *Which of the balancing market mitigation options do you consider most appropriate, i.e. MMU-triggered intervention, automated intervention via a PST or via the "flagging and tagging" approach, or prescriptive bidding controls? Where feasible please relate the preferred approach the five key principles for this workstream of effective, targeted, flexible, practical and transparent.*
17. *Which ex-ante bidding/offer market power mitigation options for the DA and ID markets do you favour – bidding principles and ex-post assessment, or ex-post assessment only? Where feasible please relate the preferred approach to the five key principles for this workstream of effective, targeted, flexible, practical and transparent.*
  - a. *If ex-ante bidding principles were to be adopted, how flexible should they be and how would this be facilitated/enshrined in their wording?*

We take these two questions (16 and 17) collectively.

We would support the SEM Committee's option 2 for DA and ID markets, with *ex ante* bidding principles focusing on times and system conditions with the greatest risk of customer harm. We would

also urge the adoption of this approach for the BM. Beyond this, to address issues of local market power in the BM, we would support an approach based on MMU-triggered intervention.

If there are reasons to believe that a party has not complied with the bidding principles, we believe there should be scope for the SEM Committee to:

- direct an approach to pricing bids and offers from that point on; and
- require resettlement of previous market outcomes to undo the harm that failure to comply with the bidding principles will have caused.

The SEM Committee differentiates in its consultation document between proposed market power mitigation strategies in the BM and DA/ID markets. This is because the document assumes the DA and ID markets are very different from the BM. The SEM Committee's quantitative analysis makes this clear. The DA modelling focuses on the physical supply stack to meet national demand, whereas the BM modelling considers the plant available to meet unexpected changes in demand.

There are clearly features of the BM (such as its single buyer nature) which mark it out from the intraday market. However, in terms of the risk of market power abuse by generators, it is not clear that it is so distinct from the ID market (leaving aside locational or non-energy considerations).

The SEM Committee's analysis of BM market power looked at metrics for the structure of the supply side of the market faced with an unexpected need for energy by the TSO one hour ahead of delivery. However, the supply side of the intraday market two hours ahead of delivery to meet an unexpected increase in demand from a retailer's customers or an unexpected reduction in either RES or thermal generation by a producer would look very similar. Based on the SEM Committee analysis, ID market buyers (and eventually customers) could therefore expect to be exposed to market power abuse for a significant proportion of the time. It is not clear why this potential abuse of market power should not be a concern to regulatory authorities.

We believe that the SEM Committee should see the markets through time not as discrete but as a continuum. It is likely to be the case that, as the market closest to real time and with the smallest potential supply, the BM is going to be most frequently exposed to the risk of market power abuse. However, the intraday market will see conditions and risks close to those in the BM towards real time. As a result, mitigation strategies need to be similar across *all the markets*, with the only real difference applied to the BM being in respect of incremental mitigation strategies to guard against the exploitation of local market power (as this is the one aspect of market power which applies to the BM but which would not apply to the near real time intraday market).

In terms of the nature of mitigation strategies, we believe a number of principles are important.

First, we would agree with the SEM Committee that it is important for mitigation measures to be effective in order to avoid customer harm. While the SEM Committee analysis shows that the HHI of the sector looks set to fall (on the basis of the scenarios modelled, and when considering market shares of energy rather than capacity), we do not believe this is a sufficient condition for a relaxation of regulatory measures relative to those used in the SEM.

The modelling also shows that there can be expected to be a significant number of hours each year in which there are few or one party supplying the last units of demand. That the industry structure is less concentrated *on average* will be of no comfort to customers facing abusive prices in high demand, low wind hours. There is no guarantee that the overall customer harm resulting from such abusive strategies would be any lower than under the *status quo*. Absent such a guarantee, it is not clear what the justification would be for a "relaxation" in relation to mitigation strategies.

Second, we believe that where regulatory intervention is expected to continue in a material way and form a core part of the regime, it is important that there is a high degree of transparency around regulatory expectations. Absent such transparency, participants may form inaccurate or risk averse views of regulatory expectations, and as a result behave in a way which is actually detrimental to customers.

The SEM Committee notes that the move to simpler bids makes auditing the link between costs and bids more difficult under ISEM than it has been under SEM. We believe this makes it *more important* to establish principles which define a competitive benchmark, as all parties will be less clear about what is acceptable. Such principles should ensure that strategies which are in customers' best interests but which could be perceived as abusive (such as pricing below SRMC to avoid a stop and a start for a unit) are put into practice rather than being avoided because of the risk of "unknown" regulatory jeopardy.

The establishment of clear principles as to what a competitive benchmark would look like ensures that participants are clear as to the expectations of the regulator, while permitting the scope for ongoing commercial optimisation and innovation within the defined benchmark.

The SEM Committee notes that a key question is whether it is possible to define principles that are sufficiently flexible and enforceable. We believe that defining set rules for the deterministic calculation of a competitive benchmark under ISEM will be difficult (we return to this issue below). However, we believe defining clear principles should be possible. Indeed, in any *ex post* enforcement, a set of principles would need to be developed either implicitly or explicitly, and would form precedent. We do not, therefore, believe that their development *ex ante* would constitute a significant additional regulatory burden or limit flexibility, and we believe that it would have significant benefits.

Third, we believe that regulatory interventions should not rely on centralised modelling of particular outcomes. There are a number of reasons to believe this would be detrimental, principal among which is that it would reduce incentives to innovation and associated revelation of actions which improve customer welfare. At the extreme, there is no longer any competitive process – the "market" simply becomes an algorithm informed by one party's view of "efficient" costs.

Furthermore, unless a centralised deterministic approach is used across all the markets in which it is possible to sell power, it is not clear how it can be effective. In ISEM, generators will be able to sell physical power in DA, ID, and BM markets. DS3 markets may also contribute to the recovery of some costs. Fixed costs associated with the production of energy (such as start up or no load costs, or costs associated with lower operating efficiency at part load) might be recovered across all these markets. The precise balance of recovery will vary from party to party based on their commercial strategy (as it should in a market). A deterministic, centralised approach to defining acceptable bid costs would presumably aim to ensure that efficient costs could be recovered once but only once. This cannot be achieved without information on the approach to bid formulation in *all markets*.

For example, some generators might aim to ensure that fixed costs are wholly recovered through DA and ID bids. For such generators, it would be inefficient to take them into account in formulating BM bids. Another generator might recover only a part of fixed costs in DA and ID markets, based on the expectation of being called in the BM. For this generator, it would be reasonable for fixed costs to be factored into BM bids.

In this sense, we do not believe that it is practical to assume that "*in the balancing market timeframe, market participants should represent any fixed costs (such as those reflected in start-up and no load costs in SEM) within their simple incremental offers and decremental bids*".

Finally, we believe that any regulations around bidding must be designed to minimise the potential for customer harm. In this sense, as soon as issues are raised in relation to a potential bidding strategy, regulatory authorities must have power to direct an alternative to be implemented while the issue is investigated. And if bidding is found to have been counter to agreed principles, it must be possible for compensation to be ordered to be paid, so that customers do not face an irreversible windfall loss.

Given the above principles, we believe that a market mitigation strategy for ISEM should consist of:

- a set of bidding principles which apply *across all markets*, and which define what a competitive benchmark would look like. These principles will fall short of dictating what the exact calculation of bids would be in any given period, but should indicate the factors which would be taken into account in assessing the competitiveness of bids, and the metrics which would be applied;

- ongoing monitoring and assessment by the MMU of the bids submitted by parties *in all markets*, and investigations where the MMU has reason to believe that bids have not adhered to the defined competitive benchmark; and
- immediate direction by the MMU to implement an alternative bidding strategy if bids are believed not to be consistent with the bidding principles, and the ability by the SEM Committee to order the payment of compensation to those harmed if the bids are eventually decided to have been non-compliant.

The bidding principles should set out the approach by which a competitive benchmark would be established for DA, ID and BM bids, focusing on times and situations in which the scope for the abuse of market power is greatest. We would also anticipate that the MMU's prioritisation in market monitoring and investigation would be driven by a view of both the probability and potential customer impact of abuse of market power in the different markets.

The key question which then remains is whether further market power mitigation is required in the BM in relation to local market power mitigation.

As we note above, we do not believe that solutions which rely on centralised calculation of bids in one market are likely to be effective. We would therefore support a regime in which the MMU identifies the potential for local market power (potentially based on automated reporting of metrics, such as RSI) and then investigates whether bids submitted are reasonable and consistent with defined bidding principles. If they are not, the MMU can take appropriate action including requiring bidding on a specified basis (taking into account the case specific context and approach to cost recovery taken by the party involved) and ordering of compensation.

18. *Under what structural conditions or in combination with other market power mitigation measures should vertical ring-fencing of the incumbents be relaxed?*
19. *Under what circumstances and criteria (or metrics) should the application of ring-fencing to other market participants be considered?*

Again, we take these two questions (18 and 19) collectively.

In the context of overall market power mitigation strategies, it is important to understand what can and cannot be achieved through vertical ring-fencing. Ring-fencing can, for example, help to ensure that:

- there is financial information available on a clear and well defined basis as to the position of firms at different levels in the value chain;
- information flows between different activities are controlled effectively;
- contracts are undertaken on an arms length basis; and
- discriminatory behaviour is minimised.

The application of ring-fencing is therefore important where there continues to be a risk that a dominant integrated party will use information abusively or discriminate between parties in a way which can damage competition.

In considering the potential for relaxing the ring-fencing requirements, the SEM Committee document makes reference to analysis undertaken by the CMA in GB showing that the integrated utilities trade both internally and externally. In GB the wholesale market structure is very different to that in ISEM. Markets are more liquid (as we show above) and there is significantly less risk of a vertically integrated generator with market power selling to its downstream entity at a different and discriminatory price from that to which it sells to third parties in order to raise rivals' costs. There are sufficient other sellers of forward wholesale power that the strategy would not be credible. Hence, GB market analogies are unlikely to be informative in relation to the ongoing need for vertical ring-fencing.

Similarly, the document considers the loss of market share by Electric Ireland. Given the dominant position of ESB's generation business, the potential for discriminatory behaviour towards its integrated

retail business would exist even with very significant retail market share loss. Hence, the level of retail market entry should not be viewed as a key consideration in relation to the ongoing application of ring-fencing conditions. Indeed, we would see the risk of discriminatory pricing by ESB's generation business as being as material in relation to SME and I&C retail as in the domestic sector.

We would therefore urge the SEM Committee not to consider the relaxation of ring-fencing conditions while:

- ESB's generation business would be able to discriminate in its sales of forward hedges in a way which would distort competition in downstream retail markets;
- ESB's retail business would be able to discriminate in its purchases of forward hedges in a way which would distort competition in the upstream generation market.

Given the SEM Committee's analysis of the likely evolution of spot market power and our arguments in relation to forward markets above, we believe this risk is likely to be present for the foreseeable future.

We believe the same test should be applied to the potential expansion of ring-fencing conditions to other parties. Only where parties are in a position to be able to discriminate credibly in their sales to retailers should ring-fencing be considered as a potential regulatory intervention.

Finally, we do not believe that there is any necessary link between the implementation of market maker provisions, as a solution to liquidity issues, and an end to ring-fencing. The market maker provisions would require a certain set of bids and offers to be posted. These bids and offers could be posted by a generator moving between long and short positions. Hence, the existence of two separate trading books within ESB's corporate portfolio has no implication for the ability of ESB to bear market maker provisions. It would imply that they would have two market maker books – which might imply additional administrative and trading costs. However, taken across the market, these costs would be less than the costs to the market and competition if ring-fencing was removed prematurely.