

**Power NI Energy Limited
Power Procurement Business (PPB)**

I-SEM Detailed Design

**Measures to promote liquidity in
the I-SEM forward market**

Consultation Paper

SEM-16-030

**Response by Power NI Energy
(PPB)**

3 August 2016.



Introduction

PPB welcomes the opportunity to respond to the consultation on measures to promote liquidity in the I-SEM forward market.

PPB has responded fully to consultations on Market Power and to the discussion paper issued in February 2015 relating to Forwards and Liquidity. PPB has also engaged with the RAs and their consultants through participation in the Forward Market Liquidity Working Groups, in bilateral meetings and in the Workshop relating to this consultation paper.

We are very concerned that while the problem of market dominance is identified as the primary issue, the options presented in the consultation paper focus on addressing the symptoms rather than seeking to address the underlying problem. This approach risks creating spurious liquidity that will not address the requirements of suppliers and customers.

Further, three of the four options (i.e. ignoring Option 1 which could co-exist with each of the others) involve the full re-integration of ESB which we believe would totally foreclose the market and create wider issues across all areas of the I-SEM including the energy markets, the CRM and DS3. It is also perverse that removal of ring-fencing between the Viridian businesses is discounted yet they are considerably smaller in scale and any re-integration within Viridian would have minimal impact on any of the market share metrics. Such an approach raises concerns that the sole motivation for these three options is a concession traded in exchange for ESB's agreement to a higher Forward Contracting and/or Market Making obligation.

We are also concerned that the consultation makes many sweeping assumptions and makes a number of assertions that are not supported by any substantiated evidence or analysis (or indeed conflict with the analysis) and which makes it virtually impossible to provide a coherent response.

Viridian Group has obtained an independent review, focusing on Options 2 to 5 of the consultation paper, from NERA Economic Consulting¹ ("the NERA paper") which this response draws upon and which is attached as part of this response.

¹ NERA paper titled "Response to the SEM Committee's Consultation on Liquidity – 29 July 2016"

General Comments and Conclusions

Option 1 relating to the development of a centralised exchange is a standalone option and while it could assist in making forward trading easier, it is not possible to commit in the absence of detailed information on the structure and costs of transacting through such an arrangement. This can be assessed more fully once further detail is known.

Options 2 to 5 have been proposed by the SEMC as options to improve liquidity in the I-SEM forward market. The attached NERA paper was procured by Viridian Group to provide an objective assessment of the basis of intervention and the merits of each of these options.

NERA conclude that the policy options presented in the consultation paper are poorly-developed and focus on the symptom (illiquidity) of a problem rather than the problem itself (market power). As NERA indicate throughout their report, the SEMC should instead target policy interventions in forward markets in a way that improves the competitive structure of wholesale and retail markets in the I-SEM, by providing a level playing field in suppliers' access to hedging.

The following represents a summary of NERA's conclusions and further detail is provided in our responses to the consultation questions below, with the full detailed assessment available in the NERA paper.

1. The SEM Committee's proposed interventions fail to identify the underlying market failure or demonstrate that the benefits of intervention exceed the costs

The SEMC's consultation is poorly founded. Liquidity, however the SEMC defines it, is the by-product of a competitive industry. Implementing a measure that increases a particular measure of liquidity does not improve competition, which is the SEMC's ultimate goal.² SEMC's efforts would be better focused on using forward contracts to mitigate ESB's market power and to transfer title over generation from ESB to suppliers who are short of generation. This would allow smaller companies to compete on an equal basis with ESB and will ultimately lower prices for consumers.

Although the F&L Workstream cannot hope to promote a liquid market, it can help traders compete more effectively by helping to provide a level playing field for hedging. The SEMC's dismissal of market power in the forward market is an over-simplification. In particular, the SEMC's position is based

² SEM Committee, *Integrated Single Electricity Market (I-SEM) – Measures to promote liquidity in the I-SEM forward market – Consultation Paper* (SEM-16-030), p8.

on a misunderstanding of effect of hedging, the costs of adopting a speculative contract position, and the consequent barriers to entry into forward markets.

Measures to promote liquidity are not costless and are not guaranteed to produce a positive net benefit for society. Many of the interventions proposed in the Consultation would impose additional costs and risks on the affected companies. Often, this burden would be felt more heavily by smaller companies with a less diversified portfolio of generation, a side-effect that is harmful to competition. To justify each intervention, therefore, the SEMC would need to provide objective evidence not only that each measure is “aimed” at a problem, but also that each measure is likely to produce a well-defined and beneficial outcome whose benefits exceed the costs of intervention.

2. The Forward Contract Sales Obligation (Options 2 and 3) is not targeted enough

The purpose of the FCSO needs to be restated and its design reconsidered. Rather than aiming at nebulous or arbitrary measures of liquidity, the FCSO is better used to create a level playing field in (i.e. to equalise) suppliers’ access to hedging products. Imposing obligations on non-dominant generators will not produce any beneficial increase in liquidity but would impose significant costs and risks on smaller generators.

3. The Market Maker Obligation (Option 4) imposes unnecessary risks and costs without evidence of offsetting benefits for consumers

The MMO attempts to treat the symptom rather than the cause of illiquidity and does not address the structural shortage of hedges in the I-SEM or the existence of a dominant market participant with a balanced portfolio.

The MMOs implemented in Great Britain and New Zealand are markedly different to those in the I-SEM and views on their success are mixed. There is no evidence that an MMO will achieve its stated aim of increasing liquidity in the I-SEM while it is likely to impose significant costs and risks on market participants which could increase prices for consumers.

4. The FCSO/MMO Hybrid (Option 5) does not remove the risks of each component, and limits the effectiveness of the FCSO

The SEMC’s Option 5 comprises a hybrid of the FCSO and the MMO, with the obligations on each half as large as under the pure policy options. The

underlying flaws of each component remain in the hybrid version. Moreover, the hybrid option also limits the possible benefits present in the FCSO: the lower obligation to sell power forward may reduce access to hedging for suppliers who are short and thus hinder competition in the retail market.

5. The removal of the ESB ring-fence is unnecessary and hinders competition

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

The SEMC and their consultants have previously concluded that ring-fencing is important for maintaining liquidity and protecting consumers' interests. Any proposal to remove the ring-fence would have to demonstrate either that changes in market conditions since their earlier work in 2010-12 had overturned the original case for ring-fencing, or that removing the ring-fence was necessary to achieve certain benefits that were not considered in 2010-12. The consultation provides no such justification for the removal the ESB ring-fencing.

Comments on the questions raised in the Consultation Paper

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

The paper largely captures the issue that the volume of electricity price hedges available in the SEM has been less than Suppliers would like to enable them to manage their risks. While liquidity is a symptom, the NERA paper highlights that the fundamental cause is the lack of competition that causes the illiquidity problem.

The splitting of the energy markets in the I-SEM is likely to have a further detrimental effect and we do not envisage any other aspects of the I-SEM design providing any impetus to increase volumes. As we had also previously noted, the additional complication of Reliability Options which are expected to have a strike price in excess of normal expected long run prices means most physically based forward hedges in the I-SEM will need to be re-structured to cap any payments made under the CfD at the RO Strike price. These products will be largely unique to the I-SEM and this additional complexity could impact negatively on volumes.

The critical point is that all trading in forward products is to hedge a position which, for Suppliers, is to match retail offerings to customers and for generators to lock in a margin that might be slightly more volatile if they were to float (on both the electricity and commodity prices). There is no evidence of any “speculative trading” in the SEM and given the evident shortage of hedges, that is unlikely to change in the I-SEM. Any re-integration of ESB would further reduce the availability of forward hedges.

As noted, most Suppliers are short and hence are buyers of CfDs and are unlikely to be selling any of the scarce CfDs they have procured.

In relation to generation, we disagree with the assertion that the only hedge a gas fired generator needs is a long term gas price hedge. Such an approach would “fix” the generator’s costs but not their revenues and hence such an approach would represent increased risk. It is also incorrect to say that coal price hedges are difficult to obtain. It is true that portfolio generators, such as ESB, with a range of fuel sources are better able to predict their market volumes and hence have less scheduling risk.

We agree that proxy hedges are an inefficient hedge and reliance on such hedges carries risk since the correlation between gas and electricity prices is

likely to be most ineffective during the periods of most risk, i.e. when the prices are high because of low wind output, cold weather and generator outages and not because of variation in underlying commodity prices.

We also disagree with the conclusions drawn from Figure 2 on page 19 of the consultation paper in relation to NRA pricing accuracy. The strike prices set in CfDs reflect the commodity prices prevailing at the time of the transaction. How pool prices outturn will similarly be reflective of the commodity prices on any given day. However the fact that the two end up close is not a reflection of any accuracy but rather outturn commodity prices not varying greatly and this is also influenced by averaging.

The analysis in Table 6 on page 22 is also flawed. The product data is incorrect (e.g. peak products only trade for 6 months) and hence the conclusions on the MW traded per quarter are incorrect and consequently the conclusions relating to the ratio of products derived (12/4/1) is wrong.

We disagree with the assertion that generators will be incentivised to forward contract because of potentially more volatile DAM prices. This is very dependent on the market dynamics and how generators and suppliers choose to participate in the different markets and we are not aware of any analysis having been completed to inform and validate such an assertion. The paper makes similar unsupported assumptions in relation to the utilisation of interconnector FTRs to add liquidity and takes no account of the potential energy flows on the interconnectors.

The discussion on whether wind generators would also seek to buy forward contracts is also theoretical and the outcome will, for example, depend on how the REFIT arrangements are amended.

The consultation paper erroneously indicates that a major failing in the SEM is that the CfD Master Agreements are not standardised in the same way as GTMAs. The NDC Master Agreements that were developed in 2007 were developed to act in the same way as GTMAs and ISDAs. PPB pressed for a single Master Agreement that would have enabled any DC, PSO or NDC transactions to be conducted under it. However, the RAs decided to develop separate bespoke master agreements for DCs and PSO CfDs that were also single year agreements that in the early years required renewal every year. Hence the RA decisions were a major driver of disparity.

We agree that the financial regulations also impose costs and risks for participants that need to be carefully considered and assessed. We note the proposition that a trading platform with central clearing and collateral

providers is the most pressing requirement. However as the paper notes, this may not reduce the costs for participants and a full assessment of the costs and benefits is required to identify if such an approach is beneficial.

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

The liquidity promotion measures set out in the consultation paper cover the range of potential measures that could be employed to help increase liquidity although as we have already highlighted, these are targeted at the symptoms and not at the underlying cause. Furthermore, we do not agree with the proposals for application of the measures and, as discussed elsewhere in this response and in the NERA paper, and also as noted by the SEMC in the consultation paper³, there is no requirement to remove the ring-fencing from ESB which will significantly negate any benefit the liquidity promoting measures might provide.

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

Sections 3, 4 and 5 of the NERA paper provides a comprehensive critique of the FCSO and MMO regulatory interventions proposed in the consultation paper which we will not repeat here. In summary, the conclusions are :

Option 2 : FCSO

The current proposal for option 2 is not targeted but instead applies a scatter-gun obligation with the hope of promoting some measure of “liquidity”. It will impose additional costs and risks on many smaller generators that will encourage premature exit or discourage entry, in a manner that may be discriminatory. This anticompetitive element of the design problem would be avoided by focusing the FCSO (like other remedies) on the source of the real problem, namely ESB’s dominance of forward markets. Any extension to other companies would be better justified by the desire to give all suppliers equal access to hedging, rather than by abstract notions of liquidity.

³ See 1st paragraph on page 63 of SEM-16-103

If the FCSO were to be extended beyond ESB, it should not be imposed on companies with a negative physical position (i.e. with generation less than retail sales).

Option 3 : FCSO and removal of ESB Ring-fencing

As discussed elsewhere, there appears to be no objective reason for removal of the ring-fencing within ESB in order to achieve the other elements of Option 3, i.e. the additional FCSO on ESB and the removal of Electric Ireland (EI) from DC auctions. The ring-fencing of ESB remains as much, if not more, of a requirement now as when it was introduced, and there is no justification for its removal.

The extension of the FCSO on ESB and the imposition of restrictions on EI's access and behaviour in auctions appear to be advantageous in their own right, and are worthy of consideration as amendments to Option 2.

Conclusions on FCSO

The purpose of the FCSO needs to be restated and its design reconsidered. Rather than aiming at nebulous or arbitrary measures of liquidity, the FCSO is better used to create a level playing field in (i.e. to equalise) suppliers' access to hedging products.

The FCSO can achieve this redefined purpose primarily by allocating contracts for the forecast generation of the dominant firm among a number of market participants. The FCSO can also constrain the market power of the dominant player (to the extent that it cannot influence forward contract prices by manipulating spot market prices). Option 2 should therefore be focused on ESB, but any extension to others needs to be justified.

Imposing the FCSO on other generators will not produce any beneficial increase in "liquidity", but would have to be justified by the need to equalise access to hedging products. Some of the generators awarded a FCSO in the current proposal will need to sell all their generation anyway, as they have no supply business; the FCSO would only have any effect if it further encouraged these generators to replace spot sales with forward sales. Justifying such an extension would require evidence that these generators were relying disproportionately on spot sales to dispose of their output.

Where a company starts with a negative net position (generation less than retail sales), forcing it to sell forward contracts would expose it to additional costs and risks, and to new regulatory burdens, which would harm

competition. Omitting such cases from the FCSO would not undermine its redefined purpose of equalising suppliers' access to hedging products.

If the SEMC do eventually decide that the FCSO should include generators other than ESB, the design of the contract portfolio would have to be more closely tailored to each generator's own characteristics, to avoid accusations of discrimination.

Under Option 3, the expansion of ESB's FCSO and the exclusion of EI from DC auctions should be considered as potentially desirable amendments to Option 2. The removal of ring-fencing seems not only undesirable, but also unnecessary, given the widespread recognition of ESB's special status in various other measures.

Option 4 : MMO

The MMO attempts to treat the symptom rather than the cause of illiquidity. The MMO does not address the structural shortage of hedges in the I-SEM or the existence of a dominant market participant with a balanced portfolio. As a result, the MMO offers no guarantee of access to forward contracts at reasonable prices. Lack of access to forward contracts limits new entry in generation and supply and may encourage the exit of existing market players. Moreover, because of ESB's position and the unnecessary and asymmetrical risk imposed by the MMO, competition in the I-SEM is likely to worsen as a result of its introduction.

The SEMC does not provide detailed reasoning to support imposing a MMO in the I-SEM and instead relies on precedents from Great Britain and New Zealand. The market structures in Great Britain and New Zealand are markedly different to those in the I-SEM. Moreover, in Great Britain the evidence on whether the MMO has improved liquidity is mixed. The SEMC does not therefore have robust evidence either for the specific design of MMO or for asserting that the imposition of an MMO will achieve its stated aim of increasing liquidity in the I-SEM.

In practice, imposing an MMO is likely to impose significant costs and risks on market participants. The SEMC has not considered the costs and risks associated with the MMO, in particular the potential increase in the cost of capital, which could increase prices for consumers.

Furthermore, the SEMC does not present clear reasoning for the removal of ESB's ring-fence.

- If it is necessary to be vertically-integrated to bear the cost of the MMO efficiently, companies with a large short position ought to be exempt, but that is not the position adopted by the SEMC in the Consultation.
- If it is only necessary to have financial strength, and not vertical integration, to bear the cost of the MMO efficiently, then there is no basis for the proposal to remove ESB's ring-fence.

The SEMC and their consultants have repeatedly asserted that the ring-fence is necessary to control ESB's market power and to increase liquidity in the SEM. Removing the ring-fence can only worsen ESB's incentives to trade power in forward markets, runs counter to the SEMC's stated objectives for the Forwards and Liquidity workstream of improving competition, and may increase costs for consumers. Any proposal to remove ESB's ring-fence would therefore require a full appraisal of, and consultation on, the impact of such a change on the overall electricity market in Ireland and any change would require much stronger argument than any presented in this Consultation Paper that is limited to consideration of the Forwards market.

Option 5 : Hybrid FCSO and MMO

The arguments regarding the FCSO and the MMO are equally valid for the combination of the two. There is no reason to believe that the inclusion of the FCSO would offset the negative effects of the MMO, or vice versa. In fact, by combining the FCSO and the MMO the SEMC may worsen liquidity compared to options 2 to 4, because option 5 reduces the ability of the FCSO to spread hedging opportunities among all market participants.

The FCSO component of Option 5 is smaller than in Options 2 and 3. In the absence of an obligation such as an FCSO, ESB may have a limited incentive to offer forward contracts on its generation. An obligation on ESB is thus necessary to allow suppliers who are short of generation equal access to hedging instruments, as required to promote competition. By reducing the size of the obligation in the hybrid option, the SEMC reduces the availability of such instruments and limits independent suppliers' access to hedging.

With respect to the MMO, the lower net exposure cap decreases risk for obligated companies (especially those in short positions). However, the undesirable consequences of the MMO, as already discussed, remain a concern.

This option also involves the removal of the regulatory ring-fence within ESB. For the reasons already identified, the removal of the ring-fence is not justified and will ultimately worsen competition in the I-SEM.

In summary, the change in size associated with the hybrid option limits the size of the benefits (as well as some of the risks) of the FCSO, and limits the size of the risks of the MMO. However, the fundamental flaws present in each of the pure policy options persist in the hybrid option.

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

Our response to the previous question and the detailed appraisal contained within the NERA paper provides comment on the issues that need to be considered, sets out our concerns with the approaches proposed and indicates how they can be made more effective.

However, as we have already identified, a key stumbling block is that Options 3-5 all propose the removal of ESB ring-fencing when such a measure is not required and would be detrimental to the wider competitive functioning across the various energy, capacity and DS3 markets. There are statements such as “*a market maker is not necessarily a generator or supplier, although vertical integration will strengthen the capacity of the market maker to offer terms; the key requirement is financial strength to take on market maker risk*”⁴. Given the key criteria is financial strength, it is unclear why re-integration will change the financial strength of ESB given it would remain a semi-state body regardless of any such change to the ring-fencing requirements. Similarly there is no evidence to underpin the assertion that aggregated generation and retail volumes are an appropriate proxy for balance sheet strength.

Other considerations that affect Option 2 relate to the proportionality of imposing obligations on many small parties that adds costs and risks that will ultimately be borne by customers. The lack of structure in the random selection of thresholds above which obligations would be placed, and the arbitrary nature of the product ratio (2/1/1) that will not reflect the production profiles of the smaller and non-portfolio generators, again just introduces spurious risk, while not addressing the underlying problem of market dominance.

A further issue with the options that include an FCSO (options 2, 3 and 5) relates to the access to the contracts. Where the allocation is market based, the first query is whether there is any restriction on participation in the

⁴ 1st paragraph in Section 8 of SEM-16-030 (on page 53)

auctions. For example could generators or asset-less traders participate as a buyer? Could a large supplier buy all of the products offered during auctions? The proposals do not consider such matters which further highlights the deficiency in the rigour of the SEMC's considerations prior to development of the options.

A further critical concern that applies to all the options relates to the legal viability of imposing obligations, that are financial transaction obligations, on electricity licence holders. There is no consideration of whether the RAs have the vires to impose such measures or whether a licensee has the resources available to it to enable it to comply with any such imposition. The financial market regulations now extend much further and there could be significant costs of compliance for smaller participants which would again be disproportionate to their size and would likely increase the market power of ESB who would have the resources to cope with such requirements.

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

Our preferred option is for a variant of Option 2 that is more focused and targeted at the dominant generator. There is no value to be gained from imposing disproportionate costs on smaller generators and similarly it would increase the risk for smaller vertically integrated companies who are short and would otherwise be a buyer and not a seller of forward contracts.

As we had indicated in our response to the February 2015 consultation an MMO applied to ESB may also be beneficial and is viable without changing the current ring-fencing arrangements.

The centralised trading platform should continue to be explored but it is unlikely to be a panacea and the costs and benefits will need to be carefully considered before any commitment could be made.

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

As we highlighted in our introduction above, there are many assumptions and assertions made which are then used as the basis of arbitrary decisions on the levels of obligations placed on various parties. Such an approach is similarly applied to the mix of product obligations that do not reflect the underlying profile of generation or demand for any participant, which if

imposed would expose those participants to new risks. The NERA paper also highlights areas where there is little or no evidence or rationale to support proposals presented in the paper.

Given this lack of robustness, it is impossible to answer the question on parameters⁵. For example, the industry needs to be involved in determining what products are required, the duration, trading windows, etc. it is also likely that such requirements will evolve as the market develops. The decisions on the level of obligations will clearly need to be made by the RAs/SEMC following consultation which must be based on evidence and fact rather than assertions and presumptions.

⁵ Section 11.3 of SEM-16-030