



Market Power Mitigation in the SEM

Market Monitor Identity

9th June 2006

AIP/SEM/62/06

1. Introduction

On the 7th April 2006 the Commission for Energy Regulation and the Northern Ireland Authority for Energy Regulation (“the RAs”) published a decision paper entitled “*Market Power Mitigation in the SEM*” [AIP/SEM/31/06]. That paper set out the RAs’ strategy for mitigating market power in the SEM and addressed comments on the original consultation paper.

The RAs’ market power mitigation strategy has a number of elements namely:

- Directed Contracts
- Bidding Principles
- Market Monitor
- Ringfencing
- Local Market Power measures

The elements of the strategy are designed to work in combination. The detailed implementation of these elements listed above are currently being developed. The purpose of this paper is to identify the options available to the RAs in respect of candidates to undertake the role of the Market Monitor and to propose the RAs’ preferred option.

The structure of this paper is as follows:

- Section 2 sets out the options for the market monitor
- Section 3 sets out the criteria used for assessment
- Section 4 sets out the evaluation of the options against the criteria
- Section 5 sets out the RAs’ preferred option
- Section 6 sets out the conclusion

1.1 Executive Summary

This paper outlines the RAs' thinking with respect to the identity of the market monitor for the SEM. Three options are developed namely, a stand alone entity, the market or system operator(s) and the RAs. Evaluation criteria are set out and applied to the various options. The relative merits of the various options are discussed. While all options are conceptually feasible the paper concludes that the preferred option is for the RAs to undertake the market monitoring role in the SEM. The option of a stand alone entity to monitor the market unnecessarily increases the complexity and burden of regulation in the SEM. In relation to the system or market operator undertaking the monitoring role, while there may be some efficiency gains to be made with this option, neither system operators have the required independence to fill the market monitor role and thus it is considered inappropriate for them to participate in market monitoring.

1.2 Consultation Process

The RAs request comment from interested parties on this proposal. The RAs intend to publish all comments received - those respondents wishing for certain sections of their submission to remain confidential should submit the relevant sections in an appendix marked confidential. Comments on this paper should be forwarded to Alan O'Kelly, preferably in electronic form by 5.00pm on the 23rd June 2006 to:

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2. Candidates for the Market Monitor

This section sets out a high level description of the role of the market monitor and possible candidates for the role.

2.1 Role of the Market Monitor

The specific functions of the market monitor are not the subject of this paper. However, it may be useful to review what its anticipated role is. Essentially, the market monitor will provide independent monitoring and reporting on the SEM. This monitoring and reporting is one element that will help to ensure that there is workable competition in the SEM.

The market monitor will report to the RAs and inform the RAs of significant deviations from bidding principles. This monitoring will help achieve the objective of preventing market participants from exercising market power. Adherence to bid principles will be monitored to ensure both that prices are not uncompetitively high and that incumbents cannot set prices uncompetitively low (i.e. engage in price suppression). Where non-compliance was observed the market monitor may agree corrective action with the market participant. This would be a relatively informal process and the non-compliance was due to an error or misunderstanding by the participant.

Also it is expected that the market monitor will inform the RAs of exploitation of the market rules. Given the complex nature of electricity markets it is possible that certain elements of the market design will have loop holes that participants may exploit for greater profits but which ultimately damage the interests of the customer and competition in general. The RAs are mindful of the need to keep the market design under review and to modify the rules to close any identified loopholes when warranted. In addition there may be areas of the market rules that once seen in operation require review with the aim of improving market efficiency.

The role does not lend itself to being fully codified or prescribed in a manual. The market monitor will have to use its professional judgment in some cases to determine whether a participant has failed to comply with bidding principles or when identifying a loophole.

2.2 Options

A number of options for the market monitor are available. In this section three options are outlined namely a stand alone entity, the market or system operator(s) and the RAs.

2.2.1 Stand Alone Entity

The first option considered is to appoint or designate a stand alone entity to undertake the role of the market monitor. This effectively means the creation of another regulatory body, separate from the RAs. The role and functions of the market monitor would be set out in legislation. The market monitor would have a formal duty to report directly to the RAs.

The stand alone entity would have to be experienced in electricity markets and have the necessary staff with knowledge and experience to undertake the role. The entity could be created as a permanent body with a full time staff. Alternatively, a competition could be held to select the entity. The term of the appointment could be for a fixed period, say five years, with the post being re-tendered at the end of the five year term.

However, there is little international experience with this model. The creation of a new regulatory body which reports to another is a difficult governance structure to make work. The enabling legislation for such a body would also be problematic in a market like the SEM which crosses national boundaries.

In the Netherlands, the energy regulator, the Office of Energy Regulation (DTe), and the competition authority, Netherlands Competition Authority (NMa), have set up a joint monitoring body, the Market Surveillance Committee (MSC) to monitor developments in the electricity market in the Netherlands. The MSC's role is primarily to monitor how well the various electricity markets are working and to make sure no one company enjoys an unfair advantage. The main task of the MSC is to obtain empirical facts and provide accurate analyses of the actual functioning of the Dutch electricity market, especially with respect to the electricity price development and including the behaviour of individual market parties active in this market. The NMa/DTe uses the reports of the Market Surveillance Committee for their policy decisions and for taking appropriate legal action to improve the electricity market performance, which can be a redesign of the regulatory framework or the initiation of

actions with respect to competition policy. The MSC informs the DTe periodically (once every 3 months) of the results of the analyses.

The MSC operates independently from the DTe with respect to the analyses made, the approach followed and the opinions formulated. The DTe is entitled to instruct the MSC to analyse a specific issue and/or to advise the DTe on a specific issue.

2.2.2 Market or System Operator

Another option is to designate the Market or System Operator as the market monitor. This option would entail the creation of a specific duty in the market operator(s) or the system operator(s) licence to perform the role of the market monitor. Under this option the market monitor would report directly to the RAs.

Given the position of the operator in any market, its role and access to the relevant data, it is unsurprising that the system/market operator acts as the market monitor in a number of markets. In particular in the United States, market monitoring is primarily taken on by the Independent System Operators (ISO) which then report both internally to the ISO Board and externally to regulators. FERC requires all ISOs to create a market monitoring function; some have done so using internal staff. (e.g. New England and PJM); others have contracted the position to outside vendors (e.g. New York and MISO). The reason for this is three-fold. First, FERC possesses neither staff nor resources to conduct continuous analysis of all bidding behaviour in all the various ISOs. Second, the US paradigm has always given substantial authority to individual ISOs to set their own rules as a condition of market membership; the variances in those rules between jurisdictions makes centralised administration of market monitoring difficult. Third, the independence of the governance structure of the ISOs made adding the market monitoring function a natural fit.

Nevertheless, FERC has recently created a centralised Office of Market Oversight and Investigations (OMOI) whose role includes detecting and crafting remedies to address market manipulation and other non-compliance issues by individual market participants. The OMOI was created in response to turbulence in the US power market approximately five years ago, and FERC's desire to have a more direct monitoring role so as to help detect and remedy any similar situations in the future. The OMOI was modelled loosely on agencies such as the Commodities Futures Trading Commission and the Securities and Exchange Commission.

Under the New York ISO (NYISO) Market Monitoring Plan, the Market Monitoring Unit (MMU) reports to the CEO of the NYISO, who is in turn responsible to the ISO board for monitoring activities. The MMU also works closely with a board-appointed independent Market Advisor who takes an active role in market monitoring activities. The Market Advisor aids in setting market monitoring and mitigation procedures, provides an independent assessment of the ISO and the MMU itself, and prepares the yearly market report. The independent Market Advisor reports directly to the ISO board.

In ISO New England (ISO-NE) the manager of the Market Monitor and Mitigation (MMM) group reports to the CEO and has authority to independently contact the ISO board and FERC directly, if needed. Occasionally, the MMM group also hires expert consultants to perform special analyses. Similar to NYISO, ISO-NE uses an Independent Market Advisor who assesses ISO markets and conducts independent studies as needed, often times at the request of the ISO-NE board. The Market Advisor tends to interact informally with the MMM group and reports directly to the ISO board.

2.2.3 Regulatory Authorities

The final option being considered is for the RAs to under take the role of market monitor. This is a role that both RAs undertake in the current market. However, due to the different market design and form of generation regulation envisaged, market monitoring in SEM would be markedly different from that currently undertaken.

Apart from the OMOI in the United States, there is other international experience of the energy regulator undertaking this role - particularly in most of Europe, where the regulatory body itself undertakes the monitoring of markets. Certainly both OFREG and CER have experience monitoring the current market. OFGEM in Britain and BNA in Germany, among others have the primary task to discover market abuses, often in combination with the competition authorities.

Again, there is varied practice as to whether these inquiries are carried out by the RAs own staff or whether the task is contracted out to an advisory group of some sort. Thus, while the monitoring authority might be a part of the regulatory body, there is no reason it cannot be procured in the same way a hypothetical stand alone body might be.

3. Criteria

The RAs propose to use the following criteria to evaluate the alternative options.

- **Feasibility**

The selected market monitor must be feasible to implement. In particular, the market monitor needs the necessary legal powers to be able to undertake the role effectively. The market monitor may require legal powers to compel market participants to provide commercially sensitive data and to be able to publish data without permission of the owner.

- **Effectiveness**

The market monitor will have to be effective at monitoring and reporting on the market.

- **Efficiency**

The option selected must be efficient and not lead to a duplication of effort. Ideally, the market monitoring arrangements should be simple and easy to understand.

- **Programme**

The market monitor must be operational by 1st July 2007 to allow SEM to go live.

- **Independence**

The market monitor must be independent of all participants and must not partake in the market. Of the criteria outlined above this is considered the most important. The independence of the market monitor cannot be in question as it goes to heart of market monitoring role.

4. Evaluation

The following section sets out the evaluation of the alternative options using the evaluation criteria set out above.

- **Feasibility**

All options should be feasible to implement. Primary legislation in both jurisdictions will be required to implement the SEM. The additional powers necessary to undertake the role effectively could be vested with a stand alone independent entity or with the transmission system or market operator(s). The RAs already have the legal powers to undertake the role, albeit it may be necessary to explicitly widen the remit of the RAs in this area.

- **Effectiveness**

All options from a structural point of view have a similar ability to be effective, although there may be reasons why one option may lead to increased effectiveness. It would be expected that the RAs as market monitor would tend to be more effective given its wider remit in the SEM and ability to agree any corrective actions with a market participant after non-compliance was observed. It could be argued that the Market/System Operator may be a more effective market monitor as there is likely to be increased opportunities for informal and near-real time interactions between the market monitoring staff and the operational staff. This close proximity to scheduling and dispatch operators can help the market monitor to quickly identify abnormal market behaviour.

- **Efficiency**

It is anticipated that the market monitor would be a modest entity with a staff of between three and five people. A stand alone entity chosen as the result of a competitive process may be the most efficient entity to undertake the role from an internal cost prospective, with the added advantage that the role would be renewed on a periodic basis. However, the costs of holding a competitive tender for the role and the overhead cost associated with the creation and operation of a new entity may outweigh these benefits. More importantly, the creation of a new entity in the market would increase the

complexity of market oversight and would increase the burden of compliance on participants by requiring them to interact with another body.

There may be synergies between the role of the market/system operator(s) and that of the market monitor. Given the modest size envisaged for the market monitor and the nature of the work undertaken it is unlikely that the synergies would be significant.

It is important that a close working relationship exists between the operational staff of the system/market operator(s) and the market monitor. Placing the market monitor within the system operators may lead to an improved communication with the operational staff, this would tend to support a significant efficiency gain. However, it would be expected that a close working relationship would develop regardless of where the market monitor was situated.

Another advantage to the system/market operator undertaking the role is ease of access and familiarity with the relevant data. However given the IT infrastructure being put in place to support the operation of the market, it is expected that remote access to the relevant data in the appropriate timescales will be available. Also it may be beneficial to have a fresh pair of eyes to review the data.

Placing the market monitor inside the RAs may lead to faster communication to the relevant decision makers within the RAs. However, again the effect of this may not be significant as it would be expected that the market monitor would be reporting directly to the RAs with effective channels of communication regardless of how the market monitor was constituted.

- **Programme**

The market monitor must be operational by 1st July 2007 to allow SEM to go live. The market monitor must be in a position to participate in the market trial which is scheduled to commence in early April 2007. The timeline to setup the market monitor is challenging. The selection or development process for the stand alone entity is likely to take a number of months.

Also the implementation of the SEM has put significant demands for resources on both the system/market operator(s) and the RAs. It may prove

difficult to free up resources to develop the market monitoring unit to achieve the required timelines.

- **Independence**

The market monitor must be independent of market participants and participants must be confident of this independence.

The selection process used to choose the stand alone entity can be designed to ensure the resulting market monitor is independent of all market participants. However, the selection would also require the stand alone entity to have significant experience of electricity markets. It is likely that a consulting firm may meet this requirement. However, the successful firm would be precluded from undertaking other electricity related work on the island of Ireland. Given the modest size of the market monitor, 3 to 5 people, the market monitor contract may not be attractive to the best firms.

The system operators are currently part of the incumbent electricity firms. ESB National Grid (ESBNG) undertakes the transmission system operator role in RoI. It is expected that EirGrid, an independent state owned company, will take over this role in the near future.

In NI, System Operator Northern Ireland (SONI) is a wholly owned subsidiary of Viridian. The market operator for SEM will be a contractual joint venture between SONI and ESBNG (EirGrid). The transmission arrangements in NI are currently under review. It is unclear what the ultimate ownership structure of SONI will be, but it is unlikely that SONI will be divested from Viridian by the SEM go live date. If SONI were to participate in the market monitor, it would raise questions as to its independence.

Part of the role of the market monitor is to keep market rules, including the rules in the trading and settlement code, under review to detect loopholes or areas requiring modification or improvement. Given the market and system operator(s) are party to the trading and settlement code it may not be appropriate for them to be charged with the review of the market rules.

The trading and settlement code allows the system operators to trade across the interconnector. The trades relate to residual interconnector capacity that may be available to the system operators after gate closure. While the

system operators may not compete with market participants through these interconnector trades they would have a financial interest in the market outcome.

The market operator is in essence a service provider to market participants. The trading and settlement code creates a contractual relationship, albeit a regulated contractual relationship, between the market operator and all market participants. A contractual dispute between a market participant and the market operator may lead to questions of the impartiality of the market monitor. The market monitor could be seen as a vehicle for retribution on the part of the market operator by market participants.

The RAs are, by statute, independent of all market participants. However, the RAs do not exist in a vacuum. It is possible for pressure to be applied to the RAs with the aim of achieving some desired market outcome. While this may be a legitimate concern, it is difficult to see how the market monitor would enhance the RAs ability to affect the market outcome.

5. Preferred Option

The discussion above to a large extent focuses on the need for the market monitor to be independent of all market participants and once there is no exertion of market power or gaming of the rules to be relatively indifferent to the operation of the market. The RAs meet this criterion. With respect to the remaining criteria there are some relative advantages identified with the RAs undertaking the role. In particular the wider remit of the RAs would tend to make market monitoring more effective. This leads the RAs to conclude that the most appropriate place for the market monitor is within the regulatory offices.

A stand alone entity undertaking the market monitor role has many merits, in particular its independence. However, the creation of an additional entity in the market unnecessarily increases the complexity of the market governance and consequently places an increased overhead on market participants. On efficiency grounds the stand alone entity is not considered to be the optimum solution and therefore this is not the RAs' preferred option for the market monitor.

The system or market operator(s) undertaking the role would bring with it a lot of experience of running electricity systems. However the questions related to the independence of the system operators does raise significant concerns. Obviously, the separation of SONI from the Viridian Group would be required for it to participate in market monitoring.

Also, there is an inherent conflict between either system operators or the market operator undertaking the role given that the role includes the review of the market rules. In particular the role of the market monitor will require some degree of professional judgement. It would be a concern if the market monitor could be undermined by questions as to its independence which could ultimately lead to it becoming ineffective. Therefore, this is not the RAs' preferred option for the market monitor.

6. Conclusion

Based on the above analysis, the RAs propose to jointly develop the market monitor within the regulatory offices for the SEM.