Commission for Energy Regulation,
The Exchange, Belgard Square North,
Cookstown, Dublin 24, Ireland

Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED

By e-mail: matanasova@cer.ie;
Ian.McClelland@uregni.gov.uk

Nord Pool AS
Vollsveien 17 B
PO Box 121
NO - 1325 Lysaker

T +47 6710 9100
Org. nr: 984 058 098
nordpoolgroup.com

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Consultation on EIRGRID and SONI proposal for arrangements concerning more than one nominated electricity market operator (NEMO) in a bidding zone

Dear Ms Atanasova and Mr McClelland,

Nord Pool AS welcomes the opportunity to comment on Egrid and SONI's Proposal for arrangements concerning more than one NEMO (MNA) in I-SEM.

Our key message is that, in our view, any multi-NEMO arrangement should meet a minimum set of fundamental requirements:

1. The ability to calculate a Single System Price for the I-SEM

2. A requirement on the concerned NEMOs to execute coupling within the I-SEM also when the fallback procedures are triggered (i.e. to share their order books and produce a single price for each market time unit)

3. The implementation of efficient and low-cost clearing and arrangements for single day-ahead and single intraday coupling, in accordance with Article 77 of the CACM Regulation

4. The implementation of simple and efficient shipping arrangements, including a split between Physical and Financial Shipping

These features are described in more detail in section 1 below.

Nord Pool believes that, of the three multi-NEMO arrangements described in the Proposal, the Nordic ones most closely fulfil such requirements. However, the Nordic model has, in its current form, some severe limitations with regards to the shipping arrangements, which will be described in more detail in section 1.1.4 below.

Section 1 – Key features of Multi NEMO arrangements

1.1 Preservation of a single system price for the concerned bidding zone(s) in all circumstances.

The first fundamental aspect of any multi-NEMO arrangement is the preservation of a single system price for the concerned bidding zone(s) in all circumstances.

In this light, Nord Pool calls on Eirgrid to include in its MNA proposal a requirement to ensure that a single clearing price for the I-SEM (Common System Price for the I-SEM) is calculated with the complete order books of all NEMOs offering services in the I-SEM , even when the fallback procedures are applied (see point 1.2 below).

A Common System Price for the I-SEM would constitute an important reference price for financial trading in the area. As financial trades act as a hedge for physical consumption, production and trading, a Common System Price for the I-SEM would significantly enhance liquidity and risk management.

1.2 Execution of coupling in the I-SEM also when the fallback procedures are triggered

The second fundamental aspect is the preservation of the coupling of the I-SEM bidding zone even in case of only partial coupling or full decoupling of a NEMO hub.

Such arrangements are essential to ensure efficient price formation and liquidity in the I-SEM market, and ensure that:

a) no barrier to entry to new NEMOs are erected and
b) consumer welfare is maximised in the event of decoupling.

Points a) and b) are described in further detail below and in the examples provided at the end of this section.

a) Barrier to entry for new NEMOs in the concerned bidding zone

If NEMOs are not required to share their order books in the event of decoupling (whenever technically possible), it is very likely that market players will not sign up to a new entrant NEMO, as the new entrant will have a smaller liquidity pool, which would expose its market participants to higher prices in the event of decoupling.

As a NEMO entering a new market will have, potentially for a number of years, a smaller liquidity pool than the incumbent NEMO, this barrier to entry would persist.

A further distortion is caused by the fact that, currently, new entrants have no barriers to entry in those bidding zones where NEMOs are required to share their order books in the event of decoupling, but face a barrier in the bidding zones which have not set such a requirement.

The outcome of the current situation is that NEMOs face a barrier to entry in the CWE and GB bidding zones, but not in the Nordic and Polish bidding zones. If unaddressed, such distortion is likely to affect more NEMOs and materialise in more bidding zones, as more Member States mandate competition among NEMOs over time.

Nord Pool has received direct confirmation that a barrier to entry exists from several potential customers in the CWE region, who stated that they would not join Nord Pool if there was no obligation for the NEMOs operating in the region to share their order books in the event of decoupling.

This is because, if a market participant joined a new entrant NEMO with a smaller order book (i.e. low liquidity), there would be a material risk that it would be exposed to extremely high prices in the event of decoupling. Market participants trading with the incumbent NEMO (offering a bigger liquidity pool), would face a much reduced risk in this respect, as they will have more opportunities to match their orders.

Even though decoupling is a very unlikely event, the price spikes to which market participants might be exposed are potentially so high that they are deterring them from joining new entrant NEMOs.

b) Avoidable damage to consumer welfare in the event of decoupling.

In those bidding zone where, in the event of decoupling, NEMOs are not required to share their order books whenever feasible, consumer welfare would be reduced even further, as compared to those bidding zones which require NEMOs to share their order books. This is because:

- Market decoupling will always lead to reduced welfare for consumers as compared to a situation where markets are coupled.

- In any decoupling scenario, a fair and efficient price formation cannot be achieved, as only a fraction of the original multi-NEMO shared ordered books is available to market participants. As a consequence, prices would diverge substantially from the prices that could normally be expected in a coupled scenario.

- Damage to consumers in a decoupled bidding zone would be compounded if the order books of the NEMOs operating in the decoupled bidding zone were not shared, as liquidity within that zone would be split even further. Market participants would pass on to consumers the costs of dealing with the (higher) price spikes.

- If, in the event of decoupling, NEMOs were required to re-open and re-share their order books, prices would not spike as much, and the impact on final consumer would be lower (albeit still negative).

Example 1

Take a bidding zone with 2 operating NEMOs and 100 active spot market participants. The incumbent NEMO has 90 participants, and the new entrant has 10 participants.

In the event of decoupling, it is likely that market participants of the incumbent NEMO would still be able to match their orders, albeit probably at a higher price than in the event that the market was coupled. Market participants who have joined the new entrant NEMO, instead, would find matching their orders very difficult as they would have only 9 potential matching orders per market time unit (MTU) as opposed to 89 potential matches. It is very possible that the none of them would be able to match any orders at all, and that the new entrant NEMO would be unable to produce a single price in the affected bidding zone.

What is more, the 10 market participants would have to scramble to balance their portfolios on the OTC market in the very short time available before the BRP scheduling commences.

This is a very realistic scenario in the first 2 to 5 years of competition, which can only be addressed by setting an obligation on NEMOs to share their order books in the event of decoupling.

Example 2

Take a bidding zone with 3 operating NEMOs and 100 active spot market participants. In the event of decoupling, the price formation will be extremely inefficient if the liquidity of the bidding zone is split into 3 smaller pools of, for example 50, 30 and 20 participants each. For the smaller NEMOs, the outcome would be similar to that described in example 1.

The situation could be made even worse, if, for example:

- NEMO 1 had mainly buyers,
- NEMO 2 had mainly sellers, and
- NEMO 3 had a good mix of buyers and sellers with inflexible portfolios

The combined order books, when shared, form could lead to a fair price formation event in the event of decoupling, if the order books were merged. However, if the order books of the 3 NEMOs were not merged, there would be a high probability that NEMO 1 would get average prices of over 1000 EUR/MTU, NEMO 2 would get prices close to 0 EUR, and NEMO 3 might fail to set prices altogether since most of its market participants' portfolios are inflexible. Had the order books been merged, the average prices could very well have been around 50 EUR on average, as compared to a price of 40 or 60 EUR in a 'coupled' scenario.

1.1.3 Efficient and low-cost clearing and settlement for single day-ahead and single intraday coupling

Nord Pool calls for the introduction of efficient and low-cost clearing and settlement for single day-ahead and single intraday coupling in accordance with Article 77 of the CACM Regulation.

In this respect, Nord Pool would like to draw your attention to the fact that different CCPs are subject to different regulation depending on the kind of business model which they adopt. Nord Pool, for example, is only offering the trading of physical products to its members, and is therefore not subject to EMIR regulation and the specific risk management and collateral requirements which this regulation imposes on other NEMOs/CCPs which have chosen to also offer derivatives trading. Naturally, clearing and settlement costs are higher for the latter group of CCPs than for Nord Pool. Nord Pool is of the strong opinion, that in the context of cost sharing and cost recovery, however, such higher costs, which are attributable only to the choice of business model of a CCP, must not be imposed on other NEMOs/CCPs.

1.1.4 The implementation of simple and efficient shipping arrangements, including a split between Physical and Financial Shipping

Nord Pool supports the Nordic TSO's original proposal for a "Regional Shipper Arrangement" where one regional shipper reports on all Nordic cross-border flows and NEMOs only interact with the regional shipper for settlement of the bidding zone specific net position. Nord Pool believes that a similar arrangement could be applied to the I-SEM interconnectors.

This model has the advantage that new NEMOs do not need to enter into agreements with incumbents or competitors with regards to the physical shipping, and TSO/NRA control over cross-border arrangements is maintained through a service agreement with the regional shipper. This model is highly cost efficient as cross-border shipping and operationally critical tasks are only performed by one entity. There is one regional point of contact for allocation constraints, cross-zonal physical shipping nominations and collection and distribution of congestion revenue. Governance is managed through service-level agreements. Governance is simpler since no agreements between CCPs or NEMOs are needed on a Nordic level.

The Nordic common systems already support this model, and having one single cross-border shipper is the simplest to implement in a scheduled exchange calculation. Nordic harmonisation would be reached, which is more than currently seen in CWE. Non-discrimination of NEMOs is guaranteed by design as they all interact with the regional shipper on equal basis. No agreements are required between the NEMOs.

However, Nord Pool has expressed strong concerns about the current Nordic NRAs specific proposal with regards to shipping, which are outlined below.

The shipping solution currently proposed by the Nordic NRAs, outlined in Article 5 of the NRAs' proposal, requires 'NEMOs or their associated central counter parties' to jointly be 'responsible for the physical and financial shipping resulting from the single day-ahead coupling and the single intraday coupling'.

Physical Shipping:

Nord Pool believes that in respect of physical shipping, the proposed solution does not meet CACM's objective of creating an effective and undistorted competitive environment for the benefit of the market participants and the final consumers, as well as a level playing field among NEMOs.

Nord Pool argues that the most efficient solution would be to allocate the responsibility for physical shipping (i.e. nomination and scheduling) to a single, regional entity, which is acting on behalf of the TSOs of that region. Such a solution provides operational security as the critical tasks of nomination and scheduling are only performed by one entity. In the Nordics, such solution would also be easy to implement, as the current system supports such a model.

Any solution which places responsibility for physical shipping on the NEMOs would provide a clear competitive advantage for a NEMO with a pan-European business, to the detriment of a local NEMO which is only present in a single Member State.

A NEMO with a pan-European business has balancing agreements and a business relationship in place with the TSOs of any Member State and region participating under the CACM Regulation, and is therefore able to easily arrange for the physical shipping (nomination and settlement). A small NEMO, e.g. one that is active only in one or two of the participating countries, might not have the legal and business arrangements in place and might have to purchase such service from a NEMO with a pan-European business. These arrangements would generate additional income for such NEMO, and put the smaller NEMO in subordinate position with respect to the larger one. This issue would be particularly relevant in the intraday markets, where transaction chain can span over many borders and potentially across the whole European electricity market. It is hardly conceivable that such a NEMO will be able to manage such exchange itself.

Financial Shipping:

Regarding the financial shipping, Nord Pool agrees with the shipping solution as proposed by the Nordic NRAs, insofar as it places the responsibility for financial shipping on the CCP of each NEMO. However, Nord Pool is concerned that this proposal will require the CCPs of competing NEMOs to agree on the terms for operating in the same markets, and by so doing would put the concerned entities at risk of breaching EU competition law .
In addition, Nord Pool is concerned that the CCP which needs to abide to the strictest and most expensive compliance rules, such as EMIR, (which entail setting higher collateral levels and/or additional operational requirements) may be able to impose its own, higher costs on a CCP that is not subject to such requirements, and force the cheaper CCP to pass on these additional costs onto its market participants. This situation would materialise if the concerned CCPs were allowed to charge each other cross-clearing fees (for the volumes cleared between the concerned NEMOs) based on their respective standard fees. So, by way of example, a situation where two CCPs called CCP1 and CCP2, were allowed to charge each other their own standard clearing fee, would look as follows:

- CCP 1 (the lightly regulated one), serving NEMO 1, is able to charge € 0.01/MWH as a minimum in order to be commercially viable
- CCP 2 (the heavily regulated one), serving NEMO 2, is able to charge € 0.03/MWH

- If the two CCPs need to cross-clear 50.000.000 MWH over a year, then we would have:
- Cross-Clearing costs of CCP1: €(50.000.000 MWH x 0.01) = € 500.000
- Cross-Clearing costs of CCP2: €(50.000.000 MWH x 0.03) = € 1.500.000

- Total Cross-Clearing costs: € 2.000.000

- If NEMO 1 and NEMO 2 has a 50% share of the total traded volumes each, then:

  - NEMO1 would charge NEMO 2 a net amount of € 250.000 (€0.01x25.000MWH)
  - NEMO 2 would charge NEMO 1 a net amount of € 750.000 (€0.03x25.000MWH)
  - This would entail a loss of € 500.000 for CCP1.

- CCP1 would be obliged to pass on the cost imposed by CCP 2 to its customers.

Nord Pool believes that such an arrangement would contravene Article 77(2) of the CACM Regulation, which states that 'the central counter parties and shipping agents shall seek efficient clearing and settlement arrangements avoiding unnecessary costs and reflecting the risk incurred'.

Alternatively, CCP 1 could be granted cost recovery by other means (e.g. socialised network fees) from the concerned NRAs. With cost recovery in place the CCPs would at least be held harmless from clearing fees of competitors. However, we doubt that this arrangement meets the requirements set out in Article 3 (e) and 3(i) of CACM, i.e.:

- ensuring fair and non-discriminatory treatment of TSOs, NEMOs, the Agency, regulatory authorities and market participants; and
- creating a level playing field for NEMOs;

In addition, even when cost recovery by other means was allowed, the CCP imposing cost in the form of higher clearing fees on its competitors would still have a larger revenue stream resulting from the cross-CCP volumes than the cheaper CCP. Therefore, to ensure that a level playing field between the two CCP is established, there would be a need to establish rules on the shipping in the day ahead timeframe to ensure that the concerned CCPs receive the same income from the fees applied to cross-CCP shipping. Nord Pool believes that the simplest way to address the concerned mentioned here would be to require CCPs to waive charging fees to each other.

As an alternative to an improved and adapted version of the Nordic-style arrangements described above, Nord Pool would also support the GB MNA solution with regards to shipping, which:

- requires that GB NEMOs be responsible for acting as central counter parties for clearing and settlement for the exchange of energy between biding zones, and
- does not contain a proposal on cross-border clearing and settlement arrangements that is subject to approval by the Authority under Article 77(2) of the CACM Regulation, such arrangements to be proposed separately by the relevant NEMOs.