SEM committee

Single Electricity Market

(SEM)

Amendments to the Duration of the Directed Contracts Primary Subscription Window

Decision Paper

SEM-23-026

31st March 2023

EXECUTIVE SUMMARY

This paper sets out the SEM Committee's decision if the temporary amendment made to the duration of the Directed Contracts (DC) Primary Subscription Window shall become enduring. In March 2022, the SEM Committee published a notification to market participants of their decision to introduce a six-day Primary Subscription Window. The SEM Committee also outlined amendments implemented to the process of calculating Directed Contract (DC) pricing formulae (SEM-22-017). The SEM Committee decided to implement such amendments in DC Round 18 (SEM-22-020), DC Round 19 (SEM-22-029), DC Round 20 (SEM-22-085) and DC Round 21 (SEM-23-013). The Regulatory Authorities (RAs; i.e., UREGNI and CRU) previously noted their intention to hold a consultation in Quarter 1 2023 to determine if the amendments should become enduring in subsequent DC rounds.

In order to determine if the amendment to the duration of the Primary Subscription Window shall become enduring, the RAs published a Consultation Paper on February 15th 2023 (SEM-23-015). The SEM Committee noted their intention to make a decision on the approach in advance of DC Round 22, scheduled to be held in March 2023.

The Consultation Paper invited stakeholders to respond to the following questions:

1) Do you agree that the proposed amendments to the duration of the DC Primary Subscription Window should become an enduring arrangement?; and

2) Do you agree that market participants should be obliged to participate during each day of the Primary Subscription Window in a given DC Round, i.e., suppliers would be eligible to purchase only 1/6th of their allocated volumes during each day of the six-day Primary Subscription Window?

Following the closure of the consultation window (1st March 2023), the RAs received a total of five responses to the SEM Committee Consultation Paper (SEM-23-015). The SEM Committee notes that respondent's comments varied. Comments received from market participants were generally in favour of the proposed enduring amendment to the duration of the Primary Subscription Window. Such respondents suggested that the amendment to the Primary Subscription Window has given participants options to mitigate some commodity price volatility risks and increases the timeframe to enable suppliers to arrange credit cover requirements. One respondent who disagreed with the proposed enduring amendment suggested that it may increase collateral risks and commodity price exposure risks. In addition, such respondent suggested the original rationale for introducing the amendment is no longer valid and have suggested markets have settled. Further, such respondent suggested DCs are a disproportionate measure and requested an evidence based review is undertaken to assess the requirement for the intervention.

Respondents generally disagreed with the proposal that market participants should be obliged to participate during each day of the Primary Subscription Window in a given DC Round suggested, inter-alia, that insufficient justification for the amendment was provided. Respondents suggested the measure limits flexibility for suppliers and undermines the rationale for extending the duration of the Primary Window. One respondent agreed to the proposal however they emphasised that suppliers should be obligated to participate over three days, not six.

Following careful review of responses to the Consultation Paper, the SEM Committee has decided that:

1. The Directed Contracts' Primary Subscription Window is held over six days, across two consecutive weeks, shall be implemented as an enduring amendment to the Directed Contracts process, subject to review; and
2. Participating suppliers shall not be obliged to purchase specific volumes of Direct Contracts on particular days. The current arrangement where it is entirely at each supplier's discretion as to which day(s) they choose to participate in any given Directed Contract Round shall be maintained.

Consequently, the SEM Committee will implement such amendments into the forthcoming DC Round 22, and, subject to review, subsequent rounds thereafter.

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1. Introduction

1.1 Background

Directed Contracts (DCs) are a part of the Regulatory Authorities' (RAs; i.e. CRU and UREGNI) market power mitigation strategy to ensure the benefits associated with the SEM are not undermined by abuse of market power by incumbent generators. The Subscription Rules (SEM-18-036d) for the DCs have been made evergreen.

1.1.1 Recent Amendments Made to the Directed Contract Process on an Enduring Basis

In January 2021, the RAs notified market participants of amendments to the DC process due to updates to commodity data availability (SEM-21-005). Additionally, in November 2021, the SEM Committee set out their decision to continue with the amended approach for the allocation of DCs, which involves reallocating a limited volume of DCs to smaller suppliers in each DC round (SEM-21-085).

1.1.2 Interim Amendments Introduced to the Directed Contract Process in 2022

In March 2022, the SEM Committee published a notification to market participants of their decision to introduce a six-day Primary Subscription Window. The SEM Committee also outlined amendments implemented to the process of calculating Directed Contract (DC) pricing formulae (SEM-22-017). Such amendments were implemented as a result of the unprecedented volatilities observed across commodity markets and were introduced in DC Round 18 (SEM-22-020). Due to the ongoing uncertainty in commodity markets, the SEM Committee decided to implement the amendments in DC Round 19 (SEM-22-029), DC Round 20 (SEM-22-085) and DC Round 21 (SEM-23-013). The Regulatory Authorities (RAs) previously noted their intention to hold a consultation in Quarter 1 2023 to determine if the amendments should become enduring in subsequent DC rounds.

The rationale for the introduction of a six-day Primary Subscription Window, instead of the historically standard three-day Primary Subscription Window was outlined in an Information Paper (SEM-22-017).

The rationale was as follows:

- It allows eligible suppliers to mitigate some of the fuel price volatility risks by spreading their eligible volumes over additional trading days, if they wish to do so;
- It may, dependent on eligible suppliers trading strategies, allow ESB to more effectively hedge exposure to price volatility; and
- the addition of three extra subscription dates will facilitate suppliers obtaining their applicable volumes in advance of the Supplemental Subscription Window.

The RAs published a Consultation Paper on February 15th 2023 (SEM-23-015) and invited stakeholders to respond to the following questions:

1) Do you agree that the proposed amendments to the duration of the DC Primary Subscription Window should become an enduring arrangement? If you agree or disagree, please set out your rationale; and

2) Do you agree that market participants should be obliged to participate during each day of the Primary Subscription Window in a given DC Round, i.e., suppliers would be eligible to purchase only 1/6th of their allocated volumes during each day of the six-day Primary Subscription Window? If you agree or disagree, please set out your rationale.

2. Summary of Responses to SEM-23-015

The five respondents to the consultation are set out in Table 1:

1. Bord Gáis Energy
2. SSE
3. Electric Ireland
4. Energia
5. ESB Generation and Trading

Table 1: List of Respondents

Respondent’s comments were varied, with market participants generally in favour of the proposed enduring amendment to the duration of the Primary Subscription Window, while one respondent, ESB GT, disagreed with the proposed enduring approach. Respondents generally disagreed with the proposal that market participants should be obliged to participate during each day of the Primary Subscription Window in a given DC Round. One respondent, EBS GT, were supportive of such proposal, however, emphasised the obligation to purchase volumes should be over three days, and not six days, as proposed.

2.1 Responses to Question 1: Do you agree that the proposed amendments to the duration of the DC Primary Subscription Window should become an enduring arrangement?

Four respondents in favour of the proposed enduring amendment to the duration of the DC Primary Subscription Window, noted inter-alia, the following:

- SSE and Energia noted their support of the rationale for implementing the extended duration of the Primary Subscription Window. Bord Gáis suggested the original rationale remains valid, and suggests uncertainty remains for energy commodities in Winter 2023/24 as risk drivers and uncontrollable forces exist (weather, Asian demand for LNG) which could increase volatility;

- Several respondents (Bord Gáis, Energia, SSE) suggested the amendment has given suppliers the option to mitigate some fuel price volatility risks. However, Energia noted the rationale for implementing a six-day window is dependent if suppliers are not obliged to participate on a given day;

- One respondent (Bord Gáis) suggested market participants have adapted their internal operational processes to the extended duration.

- Energia and SSE suggested the amendment extended the timeframe for which suppliers could put their credit cover requirements in place. SSE noted the additional time is valuable for market participants as a three-day window could prove as a barrier to some market participants who may be "timed out". Cognisant of the above, Energia noted they would not agree with a six-day window if suppliers are obligated to participate on any given day during the subscription window, adding they would seek to revert back to a three-day window. Energia suggested if a three-day Primary Subscription Window was to be reinforced, the onus would be on RAs to publish DC volumes and DC pricing formulae one week earlier than present in order to facilitate the increased timeframe in obtaining credit cover .

One respondent (ESB GT) disagreed with the proposed enduring amendment to the duration of the DC Primary Subscription Window, and noted inter-alia, the following:

- the rationale for implementing the amendment is no longer required as markets have “settled”;

- the extended duration to the Primary Window increases collateral risk and commodity price exposure;

- ESB GT is placed at a disproportionate risk to exposure to commodity price changes due to the RA’s inability to update the model during a subscription window;

- suggest there is an increased administrative burden associated with the extended duration to the Primary Subscription Window.

2.2 Responses to Question 2: Do you agree that market participants should be obliged to participate during each day of the Primary Subscription Window in a given DC Round, i.e., suppliers would be eligible to purchase only 1/6th of their allocated volumes during each day of the six-day Primary Subscription Window?

Four respondents disagree that market participants should be obliged to participate during each day of the Primary Subscription Window and disagree that suppliers should be eligible to purchase a proportion of allocated volumes during each day. One respondent, ESB GT, is supportive of the measure, however, they emphasise that suppliers should be obligated to purchase volumes over a three-day (i.e., not six-day) Primary Subscription Window. All respondents suggested this proposal limits flexibility for suppliers.

Respondents comments to the proposal noted the following, inter-alia:

- Energia and SSE note no rationale or justification for such proposal was provided. Energia are strongly opposed and emphasise no consideration of the impact of the change was provided;

- Energia suggested the measure is restrictive and may impact a supplier's ability to participate in the Supplemental Subscription Window;

- Energia and SSE suggest such amendment would undermine the rationale for extending the duration of the Primary Subscription Window;

- Bord Gáis emphasise such proposed amendment would undermine supplier's hedging activities. SSE and Bord Gáis note it would impose an additional trading burden.

- Cognisant of ESB GT's agreement[1] of such proposal, ESB GT noted that administrative difficulties could arise if smaller suppliers are obliged to participate over six days and it could discourage suppliers from engaging in the DC process. SSE also suggest smaller supplier's volumes divided by one-sixth would be minimal and "needless".

- Bord Gáis stated the amendment would impact on efforts to keep customer's costs down.

- ESB GT suggests the amendment draws attention for fairness for "*both parties on either side of the trade".*

Bord Gáis suggested consideration may be given to splitting the eligible volume for suppliers into each week of the Primary Subscription Window (i.e., 50/50 split of volumes across the two weeks). The subscription day choice and volume would remain at the supplier's discretion. Bord Gáis suggest this approach would enable supplier's internal hedging processes to operate effectively and may offer flexibility for both ESB and suppliers.

[1] ESB GT stated it's support that suppliers should be obligated to purchase volumes over a three-day (i.e., not six-day) Primary Subscription Window.

3. SEM Committee Response

The SEM Committee acknowledges the points made by market participants. The SEM Committee notes that the majority of respondents are in favour of extending the duration of the Primary Subscription Window on an enduring basis. Furthermore, the majority of respondents were generally against the proposal to oblige market participants during each day of the Primary Subscription Window in a given DC Round.

The SEM Committee notes than in addition to the responses to the consultation questions certain proposals were put forward by a respondent (e.g., request for a comprehensive review of Directed Contracts, proposed removal of the Supplemental Subscription Window, amendment to the DC Concentration Model). These proposals are beyond the scope of the consultation and have not been considered at this time.

Enduring amendment to the duration of the DC Primary Subscription Window

The SEM Committee notes the majority of respondent's support the rationale for implementing a six-day Primary Subscription Window; in particular it assists market participant's ability to mitigate fuel price volatility. The SEM Committee also notes a respondent's counter view that the original rationale for the implementation of the extended duration to the Primary Subscription Window is no longer valid and their perception that market uncertainty has alleviated.

The SEM Committee emphasises that a volatile market is defined by the degree of variation of prices, not the level of prices. NBP Gas prices and EU Carbon prices are core inputs used during the calculation process of DC prices. Figure 1 and 2 below shows the highly volatile trend of various quarterly NBP and EU Carbon futures prices since 1st February 2022.

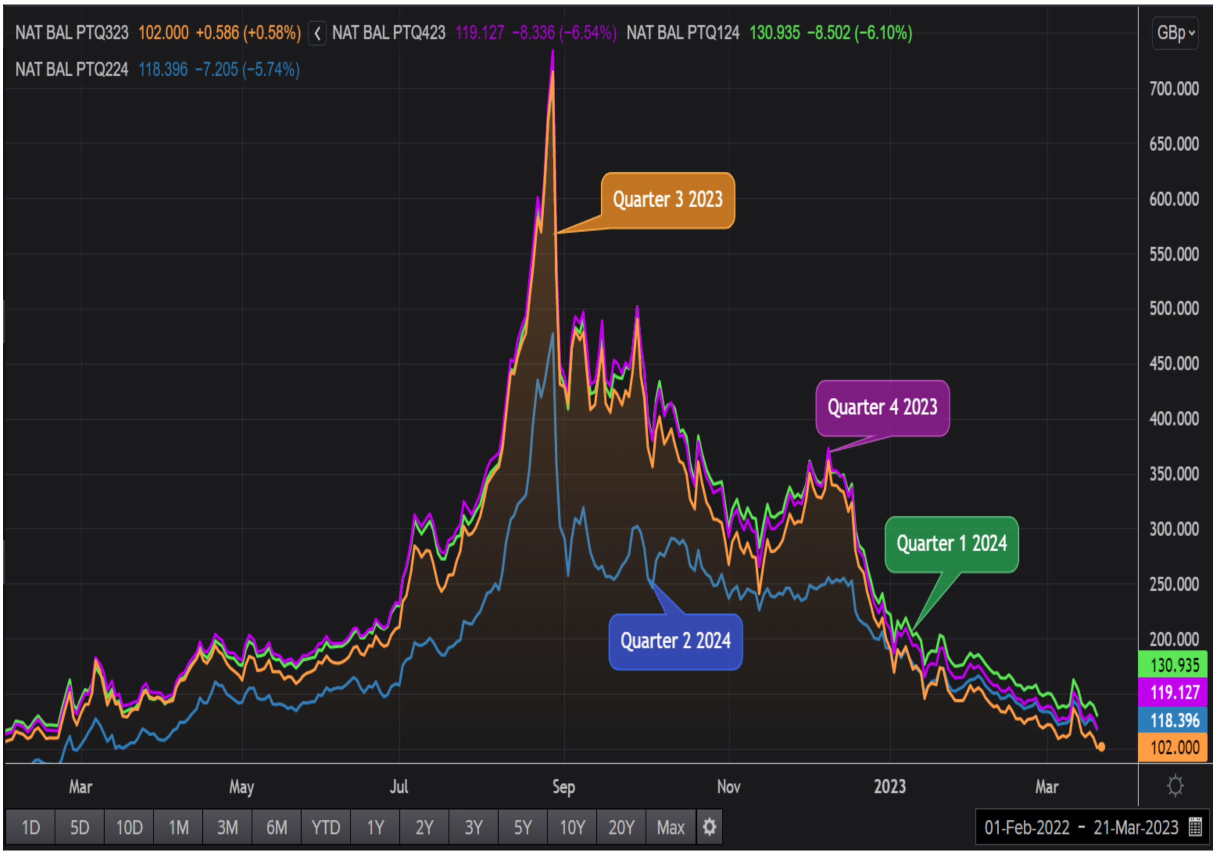

Figure 1: Price trend of quarterly NBP futures contracts (p/therm),
1st February 2022 – 21st March 2023 *(Source: Refinitiv Eikon)*

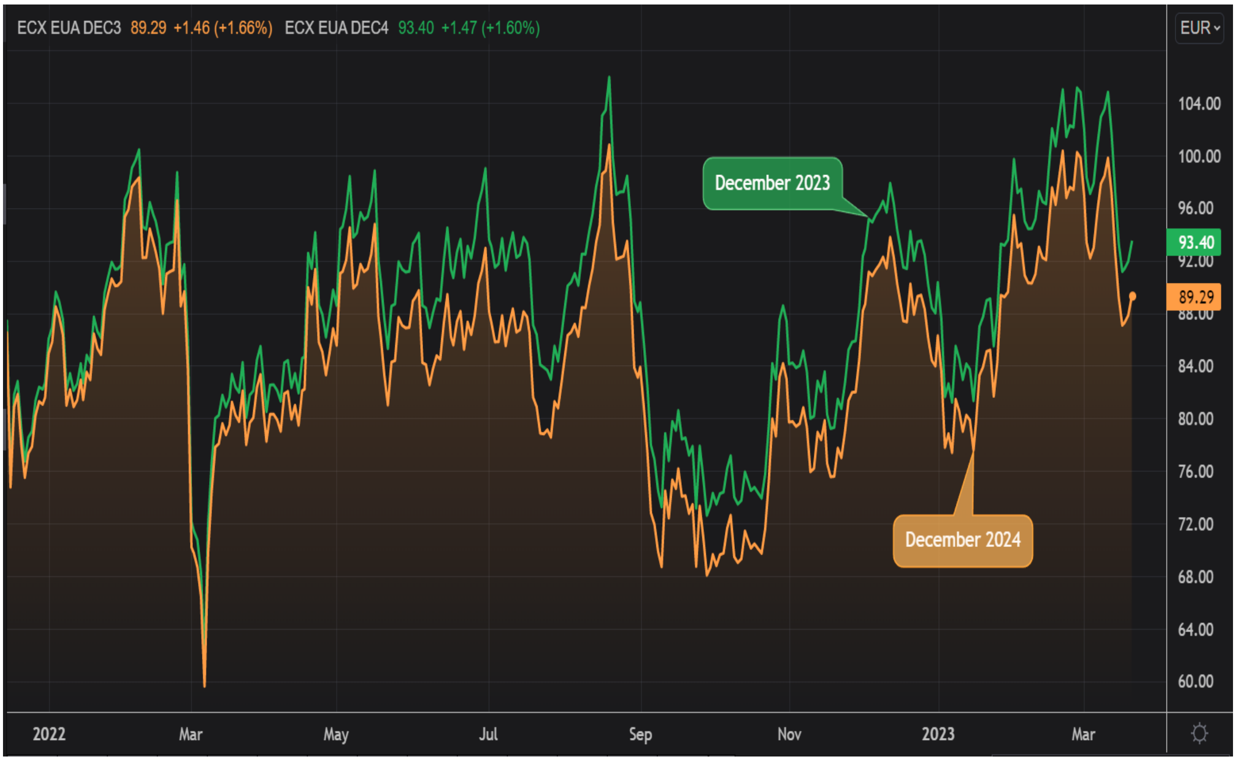

Figure 2: Price trend of EU Carbon futures contracts (€/tonne),
1st February 2022 – 20th March 2023 *(Source: Refinitiv Eikon)*

Figure 3 and 4 below shows the historical volatility of specific commodities in the four most recent DC rounds. The analysis shows the dispersion of Quarter 3 2023 NBP futures contracts and December 2023 EU Carbon futures contracts during the defined seven day subscription window dates of DC Round 18 (SEM-22-020), DC Round 19 (SEM-22-029), DC Round 20 (SEM-22-085) and DC Round 21 (SEM-23-013).

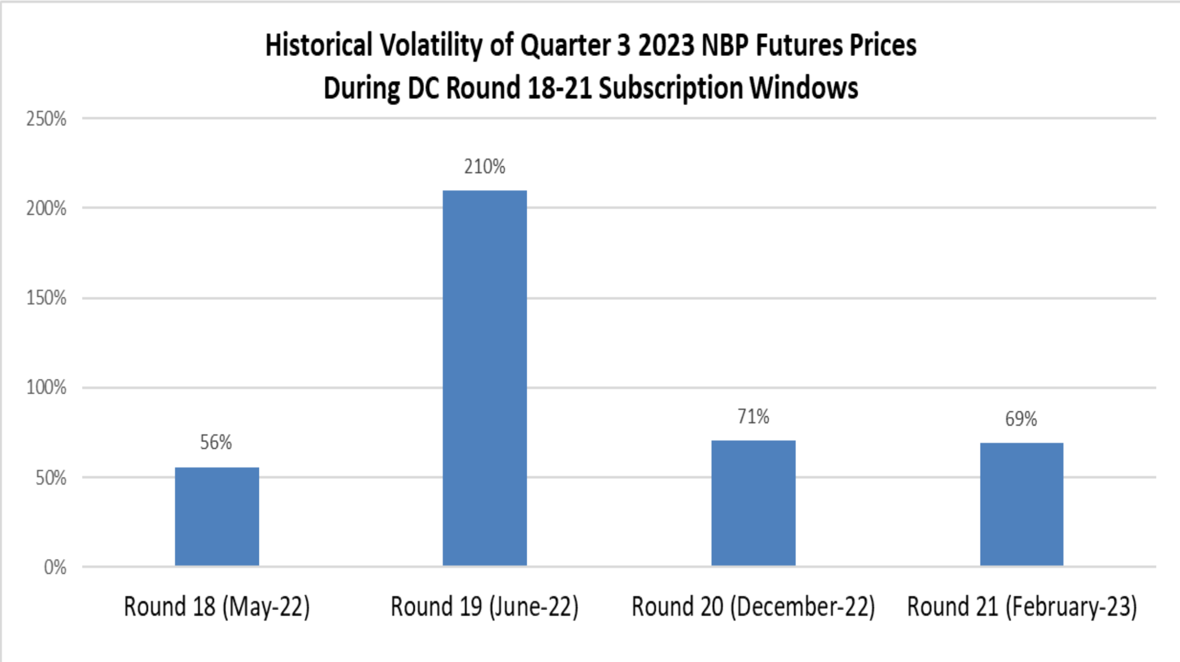

Figure 3: Annualised historical volatility of standard deviation metric of Quarter 3 2023 NBP Futures Contracts during the DC Subscription Window period

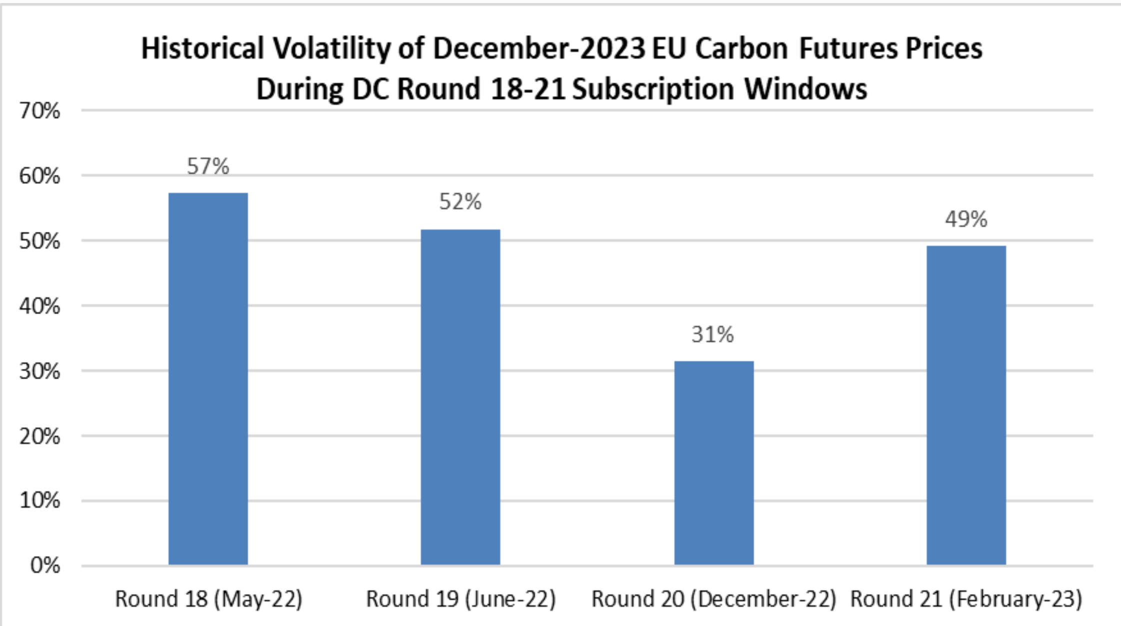

Figure 4: Annualised historical volatility of the standard deviation metric of December-2023 EU Carbon Futures Contracts during the DC subscription window period

The analysis shows the most recent rate of volatilities of both NBP and EU Carbon futures contracts has not alleviated below levels observed during DC Round 18.

The SEM Committee is of the view that various risks and uncertainty remains in the market which may increase volatility in the short and medium term. Such drivers include but are not limited to;

- global economic sentiment;
- risk of gas storage depletion;
- strong increase in gas demand used for power generation;
- significant gas production outages (Norway and the UK);
- lower renewable generation (wind);
- increased competition for LNG from Asia; and
- unexpected disruptions to US LNG imports.

The SEM Committee's principal objective is to protect the interests of consumers of electricity in Ireland and in Northern Ireland by, wherever appropriate, promoting effective competition between persons engaged in, or in commercial activities connected with, the sale or purchase of electricity.

Therefore, the SEM Committee has decided that as market uncertainty remains and given that all market participants remain exposed to potential significant commodity price volatility, a six-day Primary Subscription Window is proportionate and will be implemented on an enduring basis.

Proposal to oblige market participants to participate during each day of the Primary Subscription Window in a given DC Round

All respondents acknowledged that such proposal would limit the flexibility of suppliers. In addition, the majority of respondents raised concerns that such proposal would undermine suppliers' hedging strategies and undermine the rationale for extending the duration of the Primary Subscription Window.

The SEM Committee acknowledges a market participant's suggestion that consideration may be given to split the allocated volumes across two weeks of the Primary Subscription Window.

The SEM Committee recognises the restrictive nature of this proposal may impact on a supplier's ability to hedge and pose an administrative burden on all participants. Further, the SEM Committee is of the view that the consequential impact of this proposal is more acute for smaller suppliers who participate in DC Rounds.

On this basis, the SEM Committee has decided not to oblige market participants to participate during each day of the Primary Subscription Window in a given DC Round.

Flexibility of DC Model

The SEM Committee notes a request made by a market participant to update the DC model each day (or at least every two days) during the Primary Subscription Window period. Further, the SEM Committee rejects an additional comment made by a market participant which suggests the model underpinning DCs is inflexible in responding to new circumstances that impact market pricing. The SEM Committee emphasises the time required to execute the current DC Pricing Model means it is not feasible to publish several updated pricing formulae during a Primary Subscription Window. Further, the SEM Committee notes the RAs obtained external consultancy support to consider potential amendments to the process of forecasting DC pricing formulae within a highly volatile commodity price environment. As outlined in SEM-22-017, amendments were implemented in modelling processes and increased the flexibility of the DC Pricing Model.

Furthermore, the SEM Committee note the RAs reserve the right to suspend the DC subscription and rerun the econometric pricing model or otherwise to amend the determination of the DC CfD Fixed Prices to correct any mispricing. Updated pricing formulae was published during the DC Round 19 subscription window period, due to an unforeseen increase in the volatility in commodity markets (SEM-22-010).

Supplemental Subscription Window

The SEM Committee notes a request from a market participant regarding the removal of the Supplemental Subscription Window. The SEM Committee notes such an amendment would warrant an in-depth consultation process with all stakeholders. Such proposal is out of scope of this consultation.

Amendment to the DC Concentration Model

With reference to respondents' requests for the SEM Committee to make amendments as to how RESS supported generators are reflected in the DC Concentration Model, the SEM Committee will continue to review and update, where appropriate, its DC models (including the DC concentration model) to ensure that it provides a reasonable reflection of market conditions and that the DC volume obligations on ESB provide a reasonable reflection of its market share.

Effectiveness of DCs

The SEM Committee notes respondents' comments regarding their view of current market conditions in the SEM and their request to conduct an evidence-based review of the requirement for DCs as a market power mitigation measure. The SEM Committee notes such a comprehensive review is out of scope of this consultation.

4. SEM Committee Decision & Next Steps

Having considered the comments received, the SEM Committee has made the following decisions in relation to Direct Contracts process:

1. The duration of the Primary Subscription Window is extended to six days, across two consecutive weeks, on an enduring basis;

2. Participating suppliers shall not be obliged to purchase specific volumes of Direct Contracts on particular days. The current arrangement where it is entirely at each supplier's discretion as to which day(s) – if at all - they choose to participate in any given Directed Contract Round will be maintained.

The amendment to the duration of the Primary Subscription Window will apply as a permanent decision from DC Round 22 and in subsequent DC rounds. The SEM Committee will continue to monitor the impacts of this decision and market developments. The decision may be reviewed if market evidence shows that circumstances have changed.