Single Electricity Market (SEM)

Market Power and Liquidity Discussion Paper

SEM-20-045

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1. Introduction

In March 2017, the SEM Committee published a Decision Paper entitled, "Measures to Promote Liquidity in the I-SEM Forwards Market" (SEM-17-015), which contained the following decisions:

- Decision 1: The Regulatory Authorities (RAs) will undertake a review of liquidity in the I-SEM Forward Market 18 – 24 months after the I-SEM energy market starts operation.
- Decision 2: The RAs will engage with industry on further coverage and harmonisation of existing Master Agreements that could facilitate trading and reduce costs where possible.
- Decision 3: The RAs will under-take a review of ESB's ring-fencing requirement 18 – 24 months after the I-SEM energy market starts operation.
- Decision 4: The SEM Committee will consult upon alternatives to the current allocation process for Directed Contracts.

The purpose of this Discussion Paper is to inform market participants of the SEM Committee's intended approach to addressing the decisions within SEM-17-015 ("Forwards & Liquidity Decision Paper"), and to issue a call for evidence on market power and forward contracting in SEM. The SEM Committee welcomes feedback on this Discussion Paper and responses should be sent, preferably in electronic form, to:

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All comments received will be published on the SEM Committee website, unless the respondent clearly indicates that the relevant comment is confidential. All comments should be received by close of business on the 18th August 2020.

2. Regulatory Intervention in the Forwards Market

In the 2017 Forwards & Liquidity Decision Paper, the SEM Committee decided that it would not intervene in the forward market via the introduction of a Market Making Obligation (MMO)[1] or Forward Contract Selling Obligation (FCSO).[2]

Notwithstanding this, the SEM Committee noted that the RAs encourage the voluntary provision of these services and will engage with industry as necessary to facilitate such initiatives. The SEM Committee also noted that the RAs would undertake a review of liquidity in the forward market 18 – 24 months after the energy market starts operation (post I-SEM implementation), and the SEM Committee would then assess the functioning of the forward energy market and consult on any necessary policies.

Following the publication of the 2017 Forwards & Liquidity Decision Paper, the SEM Committee notes that there have been a number of developments in the SEM forwards market, including the following:

i. In 2019, an Over The Counter trading platform was set-up by Energy Broking Ireland Limited (EBI), who were acquired by Marex Spectron. Consequently, in SEM, market participants have two trading platform providers to choose from (i.e. Tullett Prebon and EBI) when trading forward contracts, thereby facilitating market liquidity.

ii. Marex Spectron has a designated Market Marker operating on their Trayport platform and also has continuous trading on business days from 08:30-17:00.

[1] The MMO consulted upon by the SEM Committee (SEM-16-030) considered imposing a MMO on the largest market participants (i.e. ESB, SSE, Energia & BG Energy), where such participants would be subject to a two sided obligation (i.e. they would be required to buy and sell forward generation volumes). Within the consultation paper SEM-16-030 – "Measures to promote liquidity in the I-SEM forward market", the SEM Committee noted that the objective of a market maker is that price quotes for specified products are always available for trading as opposed to a certain minimum liquidity level being reached.

[2] The FCSO consulted upon by the SEM Committee in SEM-16-030 "Measures to promote liquidity in the I-SEM forward market" considered extending the forward contract sell obligation placed on ESB in the form of Directed Contracts to other generators, based on their available modelled expected sales in the Day Ahead Market from dispatchable generation. The SEM Committee envisaged that such a FCSO would require generation to be sold in periodic auctions in the form of standardised Contract for Difference (CfD) products.

Tullett Prebon has notified the RA’s that, with a view to improve liquidity, it has decided to start the transition of Irish Power trading onto the Trayport Trading platform, which is used by participants in many European markets. The main reason for this move is that more counterparties will be able to view these prices, which Tullet Prebon note should increase both interest and liquidity in the market.

SEM Committee’s Intended Approach to SEM-17-015’s Decision 1

With regards to the above, the SEM Committee is encouraged by the organic measures that have developed to promote forward trading. While recognising the benefit of further liquidity, the SEM Committee considers it prudent to let the forwards market develop organically, and as such regulatory interventions by the SEM Committee – e.g. the implementation of an FCSO or MMO - are not intended to be progressed at this time.

3. Harmonisation of Master Agreements

In the 2017 Forwards & Liquidity Decision Paper, the benefits in reducing the barriers to forward energy transactions were noted. Consequently, the SEM Committee decided that the RAs would engage with industry on further coverage and harmonisation of existing Master Agreements that could facilitate trading and reduce costs where possible.

Subsequently, the SEM Committee consulted on ESB's proposals to amend the current Directed Contracts Master Agreement and Subscription Rules (SEM-17-065). ESB sought the SEM Committee's approval to replace the existing Directed Contracts Master Agreement and Subscription Rules with what ESB described as an industry standard model that is line with those used in other European wholesale electricity markets. This model included an umbrella framework agreement (i.e. Financial Energy Master Agreement), a Schedule of credit terms, a Credit Support Annex (CSA) based on that used by the European Federation of Energy Traders (EFET) and a Confirmation document that aligns with the International Swaps and Derivatives Association (ISDA) 2005 commodity definitions.

The SEM Committee noted in its decision paper (SEM-17-083)[3] that the revised Master Agreements provide further benefits to market participants in terms of potential standardisation of agreements and greater flexibility in terms of credit/collateral arrangements, thereby mitigating potential barriers to entry for market participants.

SEM Committee's Intended Approach to SEM-17-015's Decision 2

Given the replacement of ESB's DC Master Agreements with an industry standardised model and other recent positive developments that have taken place in the forwards market (refer to Section 2), the SEM Committee has decided that further regulatory intervention is not required at this time in terms of introducing policies to reduce barriers to forward energy transactions.

[3] SEM-17-083: Decision Paper – "ESB's Proposed Revisions to Directed Contracts Master Agreement & Subscription Rules".

4. ESB's Ring-Fencing Arrangements

Ring-fencing is a regulatory measure that is used in the SEM to separate generation and supply activities within certain vertically integrated companies that have the potential capability to exert market power. Ring-fencing provisions can include:

- Horizontal Ring-fencing Arrangements: which prevents the generation and supply businesses from sharing information and working together between units at the same level of the supply chain (e.g. different generation businesses within a vertically integrated business are separated from each other).
- Vertical Ring-fencing Arrangements: which prevent the retail and generation businesses within a vertically integrated company from sharing information and working together.

These two types of ring-fencing seek to address different aspect of the potential abuse of market power. Horizontal ring-fencing seeks to address only the capability to exert market power at the level of the supply chain to which it applies. Vertical ring-fencing seeks to address the concern that a vertically integrated company may be able to exploit market power across the supply chain.

The key benefit of vertical ring-fencing arrangements (which is currently applied within SEM for certain market participants) is that it can facilitate competition in both the retail supply and wholesale markets through:

- reducing the potential for anti-competitive behaviour (e.g. by preventing vertically integrated companies from internally hedging forward contracts, while foreclosing this market to other market participants);
- prohibiting cross subsidies and sale/purchase of contracts between generation and supply activities of vertically integrated companies, other than those which are on an arm's length basis on normal commercial terms;

- facilitating price formation in the interface between the generation and supply activities,[4] while also providing regulatory oversight (e.g. RAs can view Non-Directed Contract prices); and

- preventing vertically integrated companies from having informational or pricing advantages with respect to their competitors, which could deter competition and new entry, both in the wholesale and the retail market.

During the development of the SEM, the RAs jointly decided that, as part of a market power mitigation strategy,[5] vertical ring-fencing between affiliated generating and supply businesses within ESB and Viridian[6] groups were appropriate. The main purpose of these arrangements was to ensure that, via licenses, the businesses of ESB and Viridian operated independently of each other. They feature separate management, separate accounts, as well as a prohibition of anti-competitive behaviour, cross-subsidies (either to or from their affiliate businesses) and a prohibition on contracts with affiliates other than those on an arm's length basis on normal commercial terms.

In 2012, the SEM Committee re-affirmed its decision[7] to not allow ESB to vertically integrate on the basis that:

- the wholesale spot market was highly concentrated;

- ESB had the potential to exercise contract market power (regarding the trading of CfDs); and

[4] The SEM Committee notes that vertical integration by companies can provide a financial hedge against potentially volatile wholesale energy prices and a natural hedge against balancing risk. However, It can reduce the incentive to trade with third parties, reducing the robustness of forward market prices.

[5] Ring-fencing was referred to in the market power mitigation decision paper. AIP/SEM/31/06. The RAs consulted on appropriate ring-fencing arrangements for incumbent Suppliers in August 2005 (AIP/SEM/74/05) and then briefly again as part of a broader consultation paper in February 2007 (AIP/SEM/07/16), which was then followed by a decision in June 2007 (AIP/SEM/304/07). The SEM Committee notes that ESB Power Generation and ESBI were also horizontally ring-fenced at the beginning of SEM. However, following a public consultation, the SEM Committee decided to allow ESB to horizontally integrate these generation businesses – refer to SEM-12-002 – "Market Power and Liquidity Final Decision".

[6] Viridian has rebranded as the Energia Group.

[7] Refer to SEM-12-002 SEM Market Power & Liquidity Final Decision.

- an independent review of market power and liquidity in SEM (SEM-10-084)[8] had concluded that full integration is unfavourable as it could damage competition.

The SEM Committee noted however that if would consider any proposals for ESB vertical integration in the context of a material change to market power in the SEM (e.g. a significant reduction in ESB's generation plant portfolio), but did not provide a timescale for removal as it would depend on market circumstances.

In 2015, as part of I-SEM implementation, the SEM Committee published a consultation paper on market power (SEM-15-094)[9] and noted its general view that vertical ring-fencing of ESB and Viridian has been effective working alongside other market power mitigation measures (refer to Section 7.3.1 of SEM-15-094). However, in the context of I-SEM implementation, the SEM Committee noted that it would consider reviewing existing ring-fencing arrangements and the relevant structure conditions (in combination with other market power mitigation measures) in which vertical ring-fencing of the incumbents could be relaxed (refer to Section 8.11.8 of SEM-15-094).

In 2016, the SEM Committee published its decision paper on market power (SEM-16-024) – "2016 Market Power Decision Paper"[10], which noted that one of the key question that needs to be considered when addressing ring-fencing arrangements is whether the argument can be accepted that a competitive spot market will result in competitive forward hedging opportunities. Additionally, within Section 8.24.11 of the 2016 Market Power Decision Paper, the SEM Committee stated the following:

> "*the majority of respondents expressed the view that ring-fencing should not be removed from ring-fenced entities, in particular for ESB. The key reasoning behind this position appears to be in relation to the functioning of*

[8] SEM-10-084: Market Power and Liquidity in SEM A report for the CER and the Utility Regulator (prepared by CEPA).

[9] SEM-15-094: SEM Market Power Mitigation Consultation Paper.

[10] SEM-16-024: I-SEM Market Power Mitigation Decision Paper.

the forwards market with a general view that any removal of ring-fencing on ESB could be detrimental for forward liquidity and transparency".

Given the linkages between ring-fencing and forward liquidity, the SEM Committee stated the following within Section 8.24.11 of the 2016 Market Power Decision Paper:

"the SEM Committee is *of the view that the issue of whether any consideration should be given to amending ring-fencing arrangements for ESB and Viridian (or extending to other market participants) should be taken in the context of the work being carried out in the Forwards and Liquidity workstream*".

As part of the work on the Forwards and Liquidity Workstream, the SEM Committee stated in its consultation paper (SEM-16-30)[11] that the SEM Committee was consulting on the possibility of removing ESB's ring-fencing arrangements in the context of some options to increase the provision of hedging products to the markets. These options[12] in which ring-fencing would be withdrawn included:

- Option 3: FCSO & Removal of Ring-fencing Arrangements;
- Option 4: MMO; and
- Option 5: MMO plus FCSO.

Within the 2017 Forwards & Liquidity Decision Paper, the SEM Committee noted, inter-alia, the following:

- concerns over the impact vertical integration may have on competition were expressed in the I-SEM Market Power Mitigation Decision Paper (SEM-16-024) and the Forward Liquidity Consultation Paper (SEM-16-030), and it was acknowledged that policy options regarding the relaxation of the existing ring-fencing obligations would be addressed in the context of policy measures addressing improving forward market liquidity (refer to Section 8.1);

[11] SEM-16-030: "Measures to promote liquidity in the I-SEM forward market – Consultation Paper."

[12] Options 3-5 involved the removal of ESB's ring-fencing and as an additional feature, Electric Ireland would no longer receive allocation of DCs, which would be offered to the rest of suppliers instead.

- within the 2016 forwards and liquidity consultation paper the options for removal of vertical ring-fencing from the ESB Group were *predicated on the imposition of either an FCSO or MMO on ESB* (refer to Section 8.4).
- the SEM Committee had considered changes in market conditions that occurred since the 2010 - 2012 review of ESB's ringfencing arrangements (refer to Section 8.4).
- the CRU's concerns regarding the level of competition in the retail market in Ireland in which ESB (through Electric Ireland) retains a significant market share (refer to Section 8.3).
- the SEM Committee did not consider it prudent to make significant interventions regarding ring-fencing in advance of actual experience of the behaviour and outcomes of the new market (refer to Section 8.3).
- the SEM Committee did not consider it prudent to propose a significant decrease in vertical integration that could have a materially adverse impact on liquidity in the absence of further evidence of the state of competition in the relevant markets and without any countervailing measures being taken such as those proposed in the 2016 consultation on measures to promote liquidity (refer to Section 8.4).
- the SEM Committee did not consider that there were sufficient grounds for reconsideration of removal of ring-fencing of ESB at this point in time (refer to Section 8.4).

SEM Committee's Intended Approach to SEM-17-015's Decision 3

Overall, the SEM Committee's position regarding ring-fencing remains consistent with that outlined above. In particular, consideration regarding the potential removal of ring-fencing arrangements was to be strictly considered in the context of regulatory intervention in the forwards market. Given that the SEM Committee does not intend intervening further in the forwards market at this time, the SEM Committee therefore does not intend further reviewing ESB's ring-fencing arrangements at this time. Additionally, the SEM Committee notes that the removal of ESB's ring-fencing arrangements could create a market power risk in both the wholesale and retail markets, and potentially have negative impacts on liquidity in the SEM.

5. Directed Contracts Allocation Process

As a core pillar of the SEM market power mitigation strategy, the RAs impose forward contracts (Directed Contracts or DCs) on ESB generation such that market concentration is reduced below a certain HHI (Herfindahl-Hirschman Index) threshold, thus mitigating the incentive on ESB to engage in market power in the spot market.

In the 2017 Forwards & Liquidity Decision Paper, the SEM Committee decided that it would consult upon alternatives to the current allocation process for Directed Contracts (i.e. administered pricing), and the merits of the current process will be benchmarked against a competitive mechanism to allocate volumes.

Following the publication of the 2017 Forwards and Liquidity Decision Paper, the SEM Committee published two papers pertaining to Directed Contracts:

i. SEM-17-064 Directed Contracts Implementation Consultation Paper; &
ii. SEM-17-081 Directed Contracts Implementation Decision Paper.

The SEM Committee decided in SEM-17-081 “Directed Contracts Implementation Decision Paper” that there would be a *minimal change* approach to the Directed Contracts methodology for the first four Directed Contracts rounds (post I-SEM implementation), and confirmed that it would consult on alternatives to the current allocation process for Directed Contracts 12-18 months after the launch of the SEM.

SEM Committee’s Intended Approach to SEM-17-015’s Decision 4

In light of ongoing concerns from market participants regarding the RAs pricing of Directed Contracts, the SEM Committee is minded to consult upon alternatives to the current pricing and allocation process for Directed Contracts.

6. Call for Evidence

To facilitate the SEM Committee in making potential future policy decisions on market power and liquidity in SEM, the SEM Committee welcome stakeholders' responses to the following:

Market Power:

i. Is the electricity market sufficiently contestable that market participants are free to enter and exit the market?

ii. Do you agree with the SEM Committee's intended approach of not further reviewing ESB's current ring-fencing arrangements at this time, and outline rationale for agreeing with the SEM Committee's intended approach? If not, please outline the basis for why ring-fencing arrangements should be reviewed and either partially/entirely removed.

iii. Should the SEM Committee continue to use Directed Contracts as a mechanism for mitigating the potential use of market power in the SEM? If not, please provide rationale for not applying Directed Contract obligations, and detailed alternative options for mitigating potential market power.

iv. Assuming the SEM Committee's continuation with Directed Contracts, would you be in favour of the Directed Contracts price being determined by a competitive auction? If yes, how should the auction be designed (i.e. what should auctions be trying to achieve/avoid in the proposed design for Directed Contracts)? If not, please provide detailed alternative options (e.g. should the RAs amend the DC pricing formulae?).

v. Assuming the SEM Committee's continuation with Directed Contracts, do you agree that the Market Concentration Model (as described in SEM-17-064[13]) is an appropriate mechanism for determining Directed Contracts volumes? If

[13] SEM-17-082: Directed Contracts Implementation Paper Consultation Paper – refer to Appendix 1 within SEM-17-082 for details on how the concentration model works. Also refer to Information Paper (SEM-19-030) regarding an operational review of the Market Concentration Model for allocation of Directed Contracts volumes.

not, what amendments/alternative approaches should be taken by the RAs to determining DC volumes?

vi. Are there any specific reasons for which a market participant has not taken up their allocated Directed Contracts eligibility for a given period? (e.g. The DC price did not reflect your expectations/ already had a hedging strategy for the period in question, have access to alternative hedging products, etc.).

Forward Contracting & Liquidity

vii. In the event of no regulatory interventions regarding forward contracting in SEM, how do market participants envisage the forwards market for SEM evolving in the short, medium and long term?

viii. What actions could be taken by market participants to create greater forward contracting opportunities? Is there scope for natural growth or innovation in the forwards market, and if so, how can this be progressed? Can renewable supported generators offer hedges?

ix. On what public interest grounds should the SEM Committee decide to intervene in the forwards market in the future? In the event that the SEM Committee decide to intervene in the future, what impacts should be considered prior to intervening in the market?

7. Next Steps

Given recent market developments following the publication of the 2017 Forwards & Liquidity Decision Paper, the SEM Committee's proposed scope of work for market power and liquidity is as follows:

Decision 1: Regulatory Intervention in the Forwards Market	No further review considered at this time
Decision 2: Harmonisation of Master Agreements	No further review considered at this time
Decision 3: Review of ESB's Ring-Fencing Arrangements	No further review considered at this time
Decision 4: Review of Directed Contracts Allocation Process	Review of Directed Contract Allocation Process to take place

The SEM Committee welcome feedback on its intended approach to addressing the decisions within the 2017 Forwards & Liquidity Decision Paper, and responses to the SEM Committee's call for evidence. All comments should be received by the close of business on the 18th August 2020.