PREPAY POWER.ie
Smart control of your energy

PrePayPower Response to SEM20-045 Market Power and Liquidity Discussion Paper

31st August 2020

PrePayPower (PPP) welcome the publication of the discussion paper and we are grateful for the opportunity to respond and give context from the perspective of a non-vertically integrated supply company. We have set out our responses and supporting analysis broadly in line with the structure of the consultation paper, and in line with the four decisions taken in SEM 17-015 and the SEMCs minded to position in SEM 20-045.

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 1 PPP Position:

We welcome the arrival of the Marex platform to the market in addition to the changes to the Tullet platform. The presence of brokered platforms should help encourage liquidity. However, the existence of an OTC platform and trades there-on, does not prove that a liquid forwards market exists, nor does it mean it is competitively priced. Considering our analysis below we believe that the SEMC should at the very least give further consideration to requiring ISEM Generators to contract with all eligible ISEM Suppliers potentially through a central counterparty in order to bring all participants to market. Furthermore we believe it may also be beneficial to require that large dispatchable Generators post pricing for a percentage of their expected generation volumes over forward time frames through the use of a MMO or other suitable instrument. We note that any such consideration must be considered separately to the issue of ring fencing which is itself a separate issue and shouldn't be bundled with regulatory interventions.

We believe that it may be a quick win regardless of the action taken to display all OTC bids, offers, volumes and trades centrally in an online platform regardless of participation in the trading venue. Such transparency will help to draw trade together.

OTC Volumes

If we compare total trade on platform in 2019 and 2020 to date vs trade under the NDC category in 2015 as per SEM 17-015, then we can see a decrease in traded volumes of between 25% and 50% over the 5 year horizon. We believe that many of the contracts traded OTC and bilaterally since the beginning of ISEM are backed by traders using FTRs and GB hedges rather than from conventional or domestic assets. Any changes to FTRs due to Brexit could wipe out a lot of this trade and substantially decrease liquidity from 1st January 2021.

Period	Total GWh traded	Delta to 2015
2015 NDC from SEM 17-015	4,800	N/A
2019	2,240	-53%
Estimated 2020 To date	1,777	-63%
2020 Prorated to full year	3,047	-37%

Table 1. OTC Traded Volumes

Approximately 2.25 TWh was traded during the 2019 calendar year, this is approximately 5% of total ISEM demand in a single year. For Contrast the GB OTC power market traded 84 TWh in 2019 which is 26% of the 325 TWh annual demand. Germany which is regarded as one of the most liquid markets in Europe traded 541 TWh with a native demand of 513 TWh. In reality the traded volumes are spread out over different delivery periods however the comparison to annual demand serves for illustrative purposes as to the strength of the market.

Historic OTC traded volume in ISEM is also sporadic, with some times month to 6 week long gaps in between executed trades. Traders require reliable and predictable access to market. Offers were posted within the gaps in trade below but never executed due to price or lack of counterparty or both.

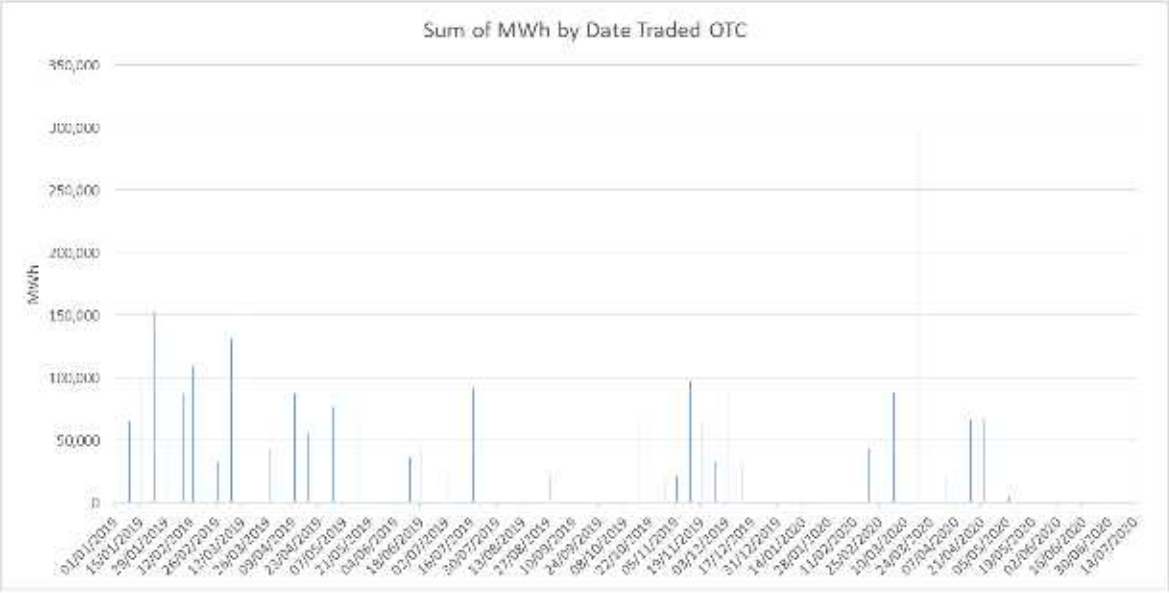

Figure 1: Cumulative Traded Volumes by date showing large gaps in trade

OTC Price Premia

Previous analysis in SEM 17-015 indicated that a price premium of 20% existed on NDC contracts. At the time the SEMC regarded this premium as acceptable. With regards to whether the 20% discussed in SEM 17-015 is an acceptable price premium, we would highlight that with wholesale costs comprising approximately one third of the overall unit rate, to hedge all demand with contracts at a 20% price premium would require that a unit rate increase of c. 7% be passed on to the end customer. Passing on such an increase would be detrimental to a supplier so it is unlikely anyone would contract at this price.

Having examined a range of counterparty and OTC trade prices we believe that price premia in the ISEM for forward contracts are still substantial with recent contracts typically averaging an 8% price premium, within a wide range up to a 21% premium depending on the tenor of the contract, time of trade the type of counterparty, and the trading venue. This analysis is based on actual traded volumes.

However, we would advise caution when interpreting these numbers, these trades are not available or easily accessible to all participants in our experience. Indeed heavily concentrated trade in particular contracts tends to depress the overall average price.

Outside of traded data, it is our experience that on screen or bilateral offers tend to exceed forecast spot prices by a greater amount. We believe that significant volumes are offered to trade at higher prices but are never dealt as they are too expensive.

We do not have access to a full set of historical volume or price data for bids and offers, so would request that the CRU attempt to analyse this data to get a true picture of the market volumes on offer and at what price. We would also request that the data is split out between internal trades for vertically integrated companies and other trades.

OTC Trade Costs

In addition to the costs of the pricing premia, due to the requirement to have multiple counterparty arrangements there are significant costs to holding credit cover with various counterparties, assuming a selling counterparty is willing to contract with you. We estimate the cost of credit at 1% to 2% of trade prices. Both exchanges also have fixed and variable fee structures which can add up to 1% to trade prices depending on the volumes traded. Some sleeveing services are available however they are not available universally and generally cost an additional 0.5% to 1% of the trade price. There are also additional staffing costs associated with on boarding with different counterparties and due to the time required to do so, they costs may also be significant.

OTC Onboarding Procedure for new Counterparty

- Onboarding and KYC with Trading Platform – typically involves fixed fee and 1 – 2 Months time
- Once onboard and systems are set up – can view prices on screen for other counterparty bids and offers
- Cant trade with anyone as not set up with counterparties
- Contact various counterparties in market and ask to be on boarded. Process can be as quick as 2 or 3 months if the Counterparty wants to trade with you or doesn't view you as a competitor. On average we have found the onboarding process to take up to 6 months per counterparty.

- If a counterparty deems you a competitor to their business they may not want to contract with you so there is no guarantee a trader will be able to access the prices on screen
- The larger sellers all require that credit cover is lodged and that collateral calculations follow the same process as in the DC master agreements requiring both Mark to Market and a 15% margin to be covered.
- The 15% margin is a barrier to trade and onboarding
- Assuming that a party has sufficient internal resources to onboard with counterparties in parallel, and can find counterparties willing to sell to it, it may be possible to onboard with sufficient counterparties in a 12 – 18 month period in order to be able to trade

OTC Trade Barriers

In summary while two OTC trading venues exist in ISEM, and we acknowledge the efforts of those venues to stimulate trade, we don't believe it is possible to say that a fully functioning OTC market exists in the ISEM. Furthermore due to the barriers to trade such as low and sporadic traded volumes, high price premia, the difficulty in onboarding with multiple counterparties, and costs of credit, we do not believe that one will exist in future either without intervention. We also have concerns as to the transparency of trading on OTC platforms and are unable to say whether pricing and trade is a result of internal trading within vertically integrated utilities or not.

We request that the RAs engage in further volume and pricing analysis of historic OTC trades across both platforms paying particular attention to the split between trades executed between vertically integrated participants, trades executed between fully independent companies, and the trades executed between vertically integrated and independent companies.

We would also request that the RAs examine the pricing of traded volumes and offer prices and bid ask spreads relative to the expected spot price at the time of trade as these are indicative of pricing dynamics also.

Our position would be that all possible barriers to trade should be removed by requiring all sellers to contract with all interested buying parties. It may be desirable to facilitate this through a central counterparty however it could be done on a mandated bi-lateral basis also. This will encourage more participation and should placate any concerns over counterparties trading internally only on the trading venues.

We believe that it may be a quick win to display all OTC bids, offers, volumes and trades centrally in an online platform regardless of participation in the trading venue. Such transparency will help to draw trade together from both sides of the market.

We would request that in order to fully encourage trade that the RAs also seriously consider the introduction of a requirement for native Generators to sell OTC some portion of their forecast volume and to contract with all interested parties through the use of an MMO or some other suitable instrument. If this was to be considered it should be done separate from any consideration of ring fencing which we believe is a separate issue to encouraging forward market trade.

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.

SEMC Position: *No change proposed*

PPP Position: The current credit terms in the DC master agreements are a barrier to trade. All large sell side counterparties with native generation in the ISEM forwards market are requiring the same 15% credit margin as ESB in the DC master agreements. There is no reasonable justification to this margin from an ESB perspective let alone any other generator. This requirement sets a barrier to forward trade in the ISEM and should be removed.

Doing so will send a signal that such a large initial credit margin is not required. In this case it will be sufficient to post cover for mark to market exposures.

In line with our request for the RAs to consider requiring all sellers to contract with all interested buyers, we would also suggest that the RAs consider some form of central credit counterparty if it can be done in a manner that would lessen the credit terms on average across the market.

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.

SEMC Position: No change proposed

PPP Position: We are in agreement with the RAs position. The risks of market power in both the Day ahead to Spot and forward timeframes is still real and needs to be mitigated. We would also comment that the decoupling of the ISEM at the Day Auction Ahead timeframe due to Brexit will immediately increase the market power of all of the vertically integrated utilities in the market not just the ESB.

We would further note that despite ring fencing, on a corporate or group basis cash still flows from the generation to the supply arm or vice versa into a central pot. If generation costs increase, the supply arm pays out more, but the generation arm receives more revenue, netting off centrally.

For that reason, even despite ring fencing it is still possible for any large vertically integrated group to influence forward or spot market prices. This should be borne in mind by the RAs when analysing any traded volumes on OTC platforms and considering interventions in forward markets

Decision 4: The SEM Committee will consult upon alternatives to the current allocation process for Directed Contracts

SEMC Position: Consult on alternatives:

"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"

PPP Position: It is our position that it is critical to the market to prevent market power and to maintain transparency that the current DC pricing and allocation process should continue. We do however suggest that the process could be improved with some adjustments for transparency and with increased allocation to non-vertically integrated participants or to participants with the lowest ratio of Dispatchable Generation vs Supply load.

The DC modelling process is critical to the market and has been a necessary and historically accurate method of ensuring transparency of pricing and the mitigation of market power. Chart 3 shows historic SEM / ISEM baseload monthly prices plotted vs the applicable DC formulae for the month in question evaluated using outturn commodity prices from that month. As can be seen the DC formulae are highly correlated with SEM outcomes and also price extremely accurately with a 7 year average delta of -0.4%.

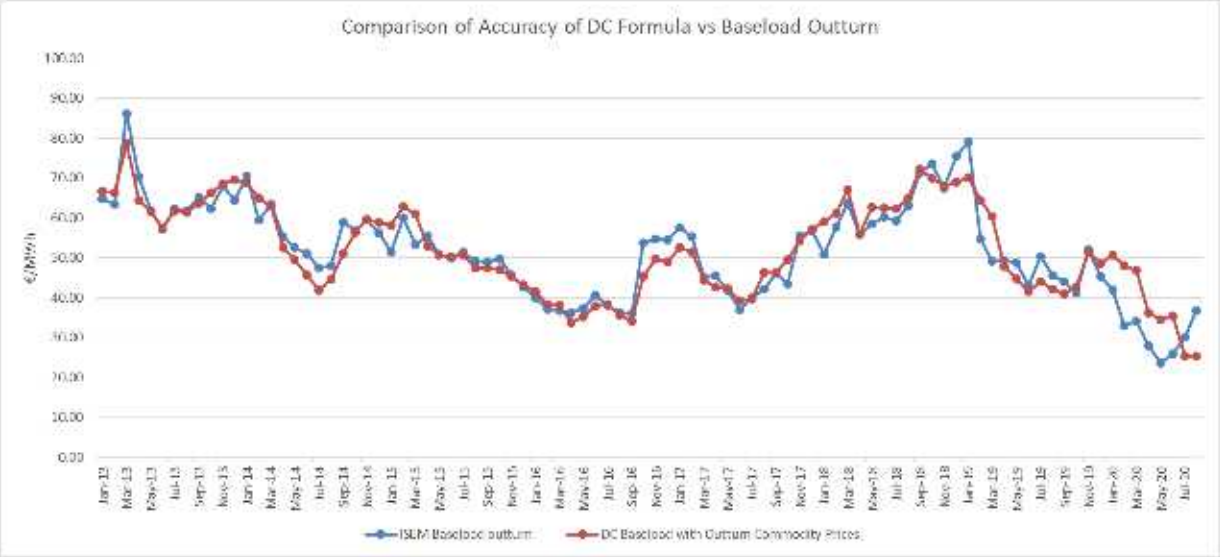

Chart 3: Baseload DC price evaluated with outturn commodities vs outturn baseload ISEM price

In recent correspondence with the RAs we have noted the volatility of DC pricing in recent rounds which led to very low uptake of certain products across the market. We expressed concerns over the pricing of winter products covering DC rounds 9&10 in particular. Relative to our own models, and the preceding DC round we believe that DC rounds 9&10 priced winter products at a 5% to 10% premium to the actual spot forecast price. We noted that there was an extremely low take up of Q1 products in rounds 9&10 across the market.

More recently in Round 11 pricing has flipped back to price 20% lower across the board relative to rounds 9&10. Given that the underlying model has not changed it is difficult to assess what could actually have caused such a robust change in price.

Outside of this year, and barring one earlier corrected pricing mistake, the DC price and underlying model has been a stable and accurate forecast of the cost of the spot market. As such, it has achieved its goal as a tool to assist in controlling market power.

While we understand the RAs reluctance to influence the forward market unduly, it is our strongly held position that the current pricing arrangements must be maintained, subject to some improvements in transparency. We would respectfully suggest that the key to accurate pricing is to have in house expertise skilled in and frequently using the modelling tools who are also familiar with spot and forward market dynamics. It may be beneficial to the market in the long run for the RAs to further build their own experience up in-house rather than rely on consultants.

We would also suggest that, in addition to the detailed commentary and benchmarking in the annual plexos model review, it would be advantageous to include commentary in each iteration of the DC

round coefficients to explain the updates made to the model and the reasons for any substantial changes in pricing.

We would echo the suggestion in the consultants report for the 20-21 model that all of the model inputs be shared with the market. It may be necessary to average these out by unit category to preserve confidential data but we believe that all model input costs should be published in some format in order for participants to understand the model outputs fully.

We would also suggest the formation of a modelling forum or panel comprised of Supply & Gen participants, RAs, TSO and MOs in order to assist in price development and assessment.

Call for Evidence

a) Is the electricity market sufficiently contestable that market participants are free to enter and exit the market?
PPP Response:

Yes. However, complicated and costly access to forward products can make it difficult to de-risk growth. This stacks competition in favour of the bigger incumbents.

b) 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.

PPP Response:
We agree with the intended approach and do not believe that ring fencing should be removed. Notwithstanding the ring fencing arrangements in place, we believe that so long as ESB power generation and Electric Ireland can trade in an anonymised fashion on OTC venues and/ or through DC allocations then there will always be a transfer of risk across the ESB group. In our opinion forward price is immaterial in such a transfer of risk as what one arm loses the other will gain. The volume of trade between ESB companies should be carefully scrutinised when analysing OTC volumes and prices.

c) 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.

PPP Response: Yes the SEMC should continue to use Directed Contracts as a mechanism for mitigating market power. Directed Contracts have been highly successful in doing so and should be retained in their present format. We would suggest further improvements in transparency from round to round outlining input assumption changes and the reasons for significant variations in price. We would also suggest that serious consideration is given to increasing the allocation of DC contracts to non-vertically integrated participants whilst reducing the share allocated to Electric Ireland as a measure to increase fairness of allocation.

d) 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?).

PPP Response: No, we would not be in favour of a competitive auction for DC volumes. Such an arrangement would not achieve the goal of controlling market power as there would be no guarantee that a) the auction would clear at a price reflective of the expected spot price and b) that a supplier would receive any volumes. Indeed such an arrangement would in itself be open to market power abuse given the Seller is the ESB, and the largest buyer will also be the ESB. In such an arrangement it would be possible to 'bid-up' the price to the point where it is not feasible for certain partipants to compete, resulting in zero allocation. It is highly likely that an auction will be detrimental to smaller and non-vertically integrated participants, and will not achieve the aims of the DC process.

e) Assuming the SEM Committee's continuation with Directed Contracts, do you agree that the Market Concentration Model (as described in SEM-17-06413) is an appropriate mechanism for determining Directed Contracts volumes? If not, what amendments/alternative approaches should be taken by the RAs to determining DC volumes?

PPP Response: Yes we believe that the market concentration model is broadly suitable. However we do feel that some consideration should be given to including some of the volumes of renewable generation in the broader portfolio. While such generation is not dispatchable price setting in the traditional sense, with advances in technology and siting, some renewable generators can now be modelled in a baseload sense and hence should contribute in some way to the market power of the bigger groups.

We would also request that careful consideration is given to the market concentration model in light of any changes to Interconnector coupling due to Brexit. The removal of implicit interconnection from the Day ahead market will increase the market share of ESB and some other large vertically integrated participants.

f) 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.).

PPP Response: Historically DCs have been an accurate and fair reflection of expected spot price outcomes. In certain pricing windows most notably Q1-21 in rounds 9 and 10 and to a lesser extent Q4-20, DC prices have substantially exceeded our forecast models which are also calibrated vs. spot prices.

We note that take up of Q1-21 volumes during rounds 9 and 10 were very light across the market at between 15% and 20% of total offered volumes.

g) 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?

PPP Response: Without regulatory intervention it is unlikely that traded volumes will increase significantly. We note that if Brexit removes the interconnectors from the Day ahead market in ISEM as is likely to be the case, that we can expect cancellations of FTRs which will remove substantial cross-border liquidity from the market for an undefined period. We note that in SEM 17-015 that the SEMC recorded 4.8 TWh of NDC transactions in 2015. Since then in 2019 it appears that approximately 2.2 TWh was traded OTC. From our perspective it appears that the ISEM has not resulted in an increase in forward trade, indeed the opposite appears to be the case.

h) 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?

PPP Response: In the long run offshore wind and large solar farms may help with hedging due to their higher capacity factors, however if they are supported through RESS they are unlikely to bring those volumes to market. We believe growth needs to be supported by intervention. If trading barriers are broken down then this will bring extra liquidity to both sides of the market.

i) 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?

PPP Response: As per our response above we believe that the SEMC should intervene now in the forwards market. In order to gauge how successful those interventions are we would suggest that suitable liquidity, pricing and ability to trade measures are introduced and tracked.