MARKET POWER AND LIQUIDITY

SSE Response

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INTRODUCTION

SSE welcomes the opportunity to comment on *Market Power and Liquidity Discussion Paper, SEM-20-045*. For the avoidance of doubt, this is a non-confidential response.

SSE is a large generator and supplier operating circa 2,000MW of generation in the all-island centrally dispatched SEM. We note that this consultation follows from a previous consideration of liquidity and forwards markets in 2016/17, prior to go-live of the new SEM.

We have provided a general response and where appropriate, responses under some of the specific questions posed in this discussion paper.

GENERAL RESPONSE

We acknowledge this consultation is seeking to review the original decisions of SEM-17-015, following 18-24 months of the new market. From this perspective, we support this discussion paper reviewing and reconsidering these decisions. However, with respect to the Directed Contracts (DC) mechanism we consider this paper does not provide sufficient evidence or information to recommend a review of this mechanism. The SEMC has not been clear as to what has precipitated the need to consider gathering evidence to support a replacement to the DCs mechanism, beyond mentioning stakeholder representation. Furthermore, there are no developed alternatives presented to industry for consideration that would address the continuing issue of market dominance, as the DC mechanism does. Therefore, our overall position is that there are not sufficient grounds, and it would not be prudent at this time to consider replacing the DC mechanism. We know that we share these concerns with other market participants.

We appreciate this is a call for evidence, however, the ability to assess the whole market to determine the need for intervention or change to the DC mechanism, lies within the purview of the RAs informed by analysis that can be provided by relevant internal modelling expertise. We would expect that a consultation regarding the future of the DC mechanism would be underpinned by a thorough examination of the mechanism. This is not forthcoming in this paper.

We also note that there are significant changes to market design currently being grappled with by industry, e.g. changes to priority dispatch under the Clean Energy Package, Electricity Balancing Guidelines and the effects of Brexit. Replacement of the DC mechanism would require significant development and implementation, which we do not think the market has the capacity to progress adequately at this time.

Finally, we would point to the initial very detailed responses from industry regarding liquidity, as part of the original SEM-17-015 consultation[1]. SSE also provided a response at that time, which still holds relevant thoughts regarding liquidity and forwards markets.

[1] https://www.semcommittee.com/sites/semcommittee.com/files/media-files/SEM-16-045p%20SSE%20Response%20to%20SEM-16-030.pdf

RESPONSE TO SEMC DECISIONS 1-4

We are supportive of the SEMC's conclusions in relation to Decision 2 and 3. We are supportive of the view that ringfencing for ESB should remain as is, and that master agreements have been revised and therefore do not require any further intervention.

Regarding Decision 1 regarding liquidity in forwards markets, we appreciate that this has been developing modestly. The level of churn that is appropriate for the market is still unclear and has not been evidenced in this paper. We note that despite the decision that these markets are developing, questions are outlined which raise the possibility of interventions and public interest. Industry can provide details on their experience of forward markets or what barriers we consider might be hindering its development. However, in terms of whether an intervention is necessary or not and on the what grounds, this is the remit of the RAs with supporting evidence and in consideration of requirements or ambitions for the volumes of liquidity in the market. We consider it inappropriate that industry is being asked to outline the scope and grounds upon which the RAs should consider an intervention.

We share the view with other industry colleagues that in order to determine whether the market is developing as expected and when intervention may or may not be warranted, an annual review of liquidity should be conducted by the RAs. It is also the function of the RAs to evidence the public interest grounds that may necessitate intervention, where it was felt that development has not progressed as hoped. However, without the regulatory intervention in the form of DCs, there would be no protection in place against market dominance, which we are confident will continue for some time.

Regarding Decision 4: review of DC allocation mechanism; we have focussed our response on this area as we are not supportive of this mechanism being replaced at this time. We have used the outlined questions in the paper as a guide and responded directly, as appropriate.

DIRECTED CONTRACTS MECHANISM

The market as a whole is not sufficiently contestable for free entry and exit. This can be demonstrated by the following features, the slow pace of connection policy which slows ease of entry, and the lack of clarity for repowering at existing sites, which creates additional commercial uncertainty for market re-entry at existing sites. In addition, where exit should be straightforward, there is a disconnect between the requirements in the Capacity Market process and the Grid Code requirement for notification of closure. This provides unnecessary hurdles for ease of exit, which if straightforward, could otherwise encourage entry in a timely manner to meet capacity gaps. Finally, we would note that the overall spirit of recent European electricity policy would negate the long timeframe for notice of closure specified under the Grid Code, since the focus is for a market with ease of entry and exit. These are some of the main issues to exit and entry. Unless, these and other issues are resolved, it cannot be said that the market is sufficiently contestable for entry and exit.

Furthermore, market power is a critical regulatory focus to manage dominance in the market. It has not been demonstrated that future market share will fall to such a level as to negate the need for DCs, or to encourage an alternative. There has been a high degree of awarded capacity won at recent auctions alongside an existing legacy portfolio specifically in constrained areas, which we consider will contribute to maintaining current market dominance. Therefore, given these factors, it is our view that market power still needs to be managed via the mechanism of DCs. The DCs mechanism is an imperfect but known solution to the issue of market dominance in the SEM.

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.

In the absence of a viable alternative at this time, this mechanism should remain in place. However, we would suggest that the frequency and forecast period could be improved, i.e. more frequent than quarterly and for a longer forecast period than 15 months ahead. The goal would be to make DCs comparable to the OTC and that prices of both should converge; therefore, volumes can be re-traded as needed. If this was achieved, and credit terms between the two mechanisms were also comparable, this would remove some issues with the current mechanism. However, the principle underpinning the necessity for DCs is that market dominance must be prevented, and otherwise that large market share must not unfairly influence a competitive market. Any viable alternative that may be recommended in future needs to deliver these same functions of DCs.

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?).

We consider that a competitive auction would need many additional design features to ensure it achieves the same function as DCs do, e.g. ensure that self-trades are prevented and addressing DC prices and credit terms. This would be a significant piece of work to develop where we consider that industry, TSOs and RAs are already, respectfully, fully occupied by other more urgent market design matters.

Furthermore, as above there has been no detail provided as to the form this auction could take and what evidence there is that it would meet the objectives that the DC mechanism is designed to achieve. Therefore, we would not be supportive of a move to this format, without this information.

v. 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?

The model is fit for purpose for determining volumes as long as it remains consistent with the Plexos price model used for the Directed Contracts. While it is unlikely to be perfectly accurate, the DC volumes sold to the market are consistent with the prices at which those DCs are made available at. If this were changed, i.e. to a competitive auction as suggested above, the SEMC needs to be able to reconcile the differences between their modelled price that is used to determine the contract volumes, and an auction price that could indicate a different set of contract volumes may have been more appropriate.

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.).

For periods where market participants not taking up their allocated Directed Contract eligibility, this would be because alternative hedging products (inclusive of a conservative basis risk provision) were cheaper than the price determined by the model. For example, a fuel hedge with a very large implied basis risk provision, would be a better option than a Directed Contract clean power hedge, or a clean power hedge available from another

counterparty on screen or bilaterally at a lower price. This was most recently seen for certain periods in Winter 2020, where alternative hedging products were available at a substantially lower cost to the price implied in the DCs model.