Energia response to SEM Committee Discussion Paper SEM-20-045

Market Power and Liquidity

28 August 2020

1. Introduction and Overview

Energia welcomes the opportunity to respond to the SEM Committee (SEMC) Discussion Paper (SEM-20-045) on Market Power and Liquidity in the SEM (the "Discussion Paper").

The purpose of the Discussion Paper is to inform market participants of the SEM Committee's intended approach to addressing Decisions 1 to 4 within SEM-17-015 (Forwards & Liquidity Decision Paper), and to issue a call for evidence on market power and forward contracting.

Energia strongly supports the current DC process and does not believe material change is required that would justify a consultation on alternative approaches. Energia does not support any relaxation of ESB's ring fencing arrangements as this cannot be justified given ESB's dominant position in wholesale and retail markets. Removal of the ring-fence would reinforce ESB's dominance, hinder competition and would have potential negative impacts on retail customer prices. Energia's feedback can be further summarised as follows:

1. **Decision 1** – Energia agrees with the SEM Committee's view that it is prudent to let the forwards market develop organically, and that no regulatory intervention (in the form of an FCSO or MMO) should be progressed at this time.
2. **Decision 2** – Energia agrees with the SEM Committee that recent positive developments have taken place in the SEM forward market, particularly the introduction of the Marex Spectron brokering service and that further regulatory intervention is not required at this time to reduce barriers to forward trading. However, we would encourage the regulatory authorities (RAs) to put in place a robust monitoring and reporting framework on the health of the forward market, including of ESB-Generation's sale of forward contracts to Electric Ireland. Serious consideration should also be given to increasing DC volumes made available to other suppliers to reflect Electric Ireland's 'internal hedges' through legacy contracts with Synergen and Coolkeeragh, justified on the basis of promoting competition.
3. **Decision 3** – Energia agrees with the SEM Committee 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 and ultimately retail prices, and that there are insufficient grounds for reconsideration of removal of ring-fencing at this point in time. Removal of the ring-fence would reinforce ESB's dominance and hinder competition and it should not be considered.
4. **Decision 4** – Energia disagrees with the SEM Committee's intended approach on Decision 4, as there is no justification for considering alternatives to the current pricing and allocation process for Directed Contracts (DCs), which is generally serving its intended purpose[1], and there is certainly no merit in considering an auction-based process for DCs.

As a final but important point, Energia would emphasise that now is not the right time for a detailed review of market power and liquidity in the SEM, as experience of

[1] Albeit minor improvements could be made to the current DC process, as suggested elsewhere in this response, these do not in any way constitute, or require, an 'alternative' approach.

behaviours and outcomes in the new market is still developing, new arrangements for system services are being considered, and there are likely to be significant market changes in the near future with the implementation of the Electricity Balancing Guideline (EBGL) and Clean Energy Package (CEP), not to mention the possibility of a 'no-deal' Brexit with the potential impact on the interaction of the interconnectors with wholesale prices and liquidity. Neither is it necessary at this point in time whilst we are in the midst a global pandemic and dealing with its far reaching and deeply disruptive impacts.

The remainder of this response is structured as follows. Section 2 elaborates on our concerns with the SEM Committee's intended approach on Decision 4 and section 3 responds to the questions and call for evidence posed in the Discussion Paper.

2. Concerns with the Intended Approach on Decision 4

The Discussion Paper states that the SEM Committee is minded to consult on alternatives to the current DC pricing and allocation process in light of 'ongoing concerns from market participants regarding the RAs pricing of Directed Contracts'.

It is unclear what these concerns are or where they are coming from, but the evidence is clear – with few exceptions, 100% of DCs made available are ultimately sold[2]. So, if the concern is that DCs are often priced too high, this is not borne out in the evidence.

Whilst anomalies (or errors) in DC pricing can and sometimes do occur on rare occasions, this can be addressed on a case-by-case basis without resorting to the extreme of an alternative methodology. For example, in January 2018 only 58% of Baseload Q1-19 sold in Round 1. Following concerns raised by market participants regarding the price, an error was identified within the validated PLEXOS model. This was corrected and an additional supplemental round for Round 1 was scheduled[3]. Those participants that did not pick up all their eligible volume in Round 1 were eligible to enter the adjusted round, where a further 80% of the Baseload product was sold. This is a good example of the approach that could be taken where concerns are raised and a significant volume of DCs do not sell in a particular round – i.e. carry out a review and validation of pricing when DCs do not sell. Another suggestion for minor change would be to update and release the DC coefficients closer to the subscription window to reduce the risk of coefficients becoming outdated due to market shocks.

In conclusion, an alternative approach to pricing and allocating DCs is entirely unnecessary in the circumstances, where the current approach is tried-and-tested and is generally serving its intended purpose. Whilst minor improvements could be made to the current DC process, as suggested above, these do not in any way constitute, or require, an 'alternative' approach.

It is surprising that the SEM Committee have asked (in question iii of the Discussion Paper) if Directed Contracts should continue, given that ESB remains the sole dominant player in the all-island market, as the incumbent supplier (with a large proportion of 'sticky customers), a large diverse portfolio of generation, and a

[2] The exceptions are: Round 1 (Q1-19); Round 9 (Q1-21) and Round 10 (Q4-20)
[3] See SEM-18-010 for further details.

relatively balanced generation and supply business which mitigates its need to trade with other market participants. Clearly Directed Contracts should continue, and therefore on the basis of the evidence, there is no scope or grounds for the SEM Committee to reach any conclusion other than to retain DCs. However, it concerns us that the SEM Committee are also asking (in question iv of the Discussion Paper) whether the price of DCs should be determined by a 'competitive auction'.

Auctioning DCs is not something Energia would be supportive of in any way. Given that the purpose of DCs is to constrain ESB's market power, only administrative pricing and allocation can be effective. Auctioning DCs would undermine their objective and would be detrimental to retail competition and consumer interests.

In order to explain this, let us assume that ESB generation could be required to offer their full DC obligations through an auction at an administered reserve price (which we assume would be set at a discount to the current DC formula). However, this does not address ESB's market power where Electric Ireland (EI) has the ability (large market share with high proportion of sticky customers) and incentive (harmful to competitors and beneficial to the wider ESB group) to exercise market power in the auction.

In cases where EI is the price-setting bidder, an increase in EI's bid would directly translate into an increase in DC prices and a decrease in the volumes acquired by other suppliers with a detrimental impact on retail market competition and prices to end users. In cases where EI is not the price-setting bidder, increasing the price and volume of its bid may displace lower bids and increase the clearing price in the auction, with a similar detrimental impact. Note that EI will not be concerned about inflated DC prices as, by definition being the incumbent, they have a large proportion of "sticky" customers – i.e. customers that are not price sensitive. Any payment by EI for DCs above fair value will be recoverable by EI through small increases in their retail tariffs over a customer base that is significantly larger than other suppliers.

EI will have an incentive to bid higher prices than any other supplier. On the one hand, the price in a contract between ESB Generation and EI is merely a transfer price with no implications for the profitability of the group as a whole. (This is true whether or not the two businesses are ring-fenced). On the other hand, ESB would benefit from an increased price on its hedging products across its net sales to all other bidders through the DC process and beyond (as any inflated DC wholesale price signal will influence other wholesale markets). Moreover, by increasing the volume and price of its bids EI could obtain a larger share of the DC contracts, which would leave competitors with fewer and more expensive or imperfect hedging products with a clear and obvious detriment to retail market competition.

In summary:

1. EI will be able to bid higher prices than any other supplier, since the price in a contract between ESB Generation and EI is merely a transfer price, with no implications for the profitability of the group as a whole. (This is true whether or not the two businesses are ring-fenced). EI will be able to bid for a large share of the DCs, without fear of suffering the consequences of over-payment.

2. Contracts between ESB Generation and EI do not reduce the incentive for ESB to exercise its market power, again because the contracts have no impact on the profitability of the group as a whole.
3. This approach will therefore reduce or invalidate the role of DCs in mitigating ESB Generation's market power.
4. Even if EI is prevented from taking part in the DC auctions, auctions for DCs will not settle at fair value market prices. The supply side of the market is short and so, as can be seen across traded products in general, CFDs trade at above fair market value.
5. Therefore, auctioning DCs will not provide any kind of disincentive to the exercise of market power by ESB.
6. Instead, auctioning DCs will have a detrimental impact on retail competition and will increase end user prices.

3. Consultation Questions and Call for Evidence

Below we set out our response to the questions and call for evidence in section 6 of the Discussion Paper, which should be read in conjunction sections 1 and 2 of this response.

Market Power

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

Energia response:

As we have explained in previous submissions, competition in the retail supply market is hampered by the competitive advantage that ESB derives from preferential access to hedging instruments through ESB-Generation's sale of forward contracts to Electric Ireland (through a combination of 'internal hedges' with Synergen and Coolkeeragh, DC eligibilities and NDCs)[4]. Promoting competition in the SEM therefore requires that all suppliers have equal access to hedging contracts (or an equal opportunity to gain access to such contracts), by arranging a transfer of hedging products from ESB to other suppliers. In response to question v below, we suggest how this should be addressed by reducing Electric Ireland's allocation of DCs to reflect its 'internal hedges' through legacy contracts with Synergen and Coolkeeragh and redistributing its DC allocations to other suppliers accordingly.

In terms of barriers to trading in the SEM forward market, credit remain a significant issue. The level of credit cover required, the need for separate lines of credit for different contracts, and the need for separate agreements with each counterparty increases costs and is time consuming and onerous for both large and small participants alike.

Exchange based trading with centralised clearing could possibly help alleviate the credit burden for participants as there would only be one credit requirement with the exchange (clearing member) instead of multiple agreements with each trading party.

[4] See Energia's response to SEM-16-030 for further details.

However, exchange based trading should only be considered where there is an overall net benefit from introducing such arrangements – i.e. ensuring that any benefits are not offset by increased working capital requirements and / or higher trading fees. This was not the case, based on available information at the time, when exchange based trading was last considered by the SEM Committee in 2016[5]. It could however be reviewed again in future.

In the meantime, Energia would encourage the RAs put in place a robust monitoring and reporting framework on the health of the forward market, including of ESB-Generation's sale of forward contracts to Electric Ireland.

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.

Energia response:

Energia agrees with the intended approach of the SEM Committee not to review ESB's ring-fencing arrangements at the current time, as there is no substantive and independently verified evidence to justify such a review. The vertical re-integration of ESB would present a real risk to consumer interests and would have to be rigorously assessed by the RAs for its impact on competition. The relevant Competition Authorities (CCPC in ROI, CMA in UK) with responsibility for merger assessment would also have to be consulted given their extensive experience and expertise in the area of mergers and joint ventures.

ESB remains the sole dominant player in the Irish market with a large diverse portfolio of generation and a relatively balanced generation and supply business which mitigates its need to trade with other market participants. ESB has recently strengthened its position of dominance through aggressive participation in capacity auctions to date, resulting in the award of 10-year Reliability Options for over 500MW (de-rated) of new flexible generation and storage, with the possibility of further new capacity contracts being pursued by ESB in future auctions, potentially to replace/repower Moneypoint (where one might expect ESB to have a competitive advantage in terms of site availability and / or grid connection). It is also relevant that ESB has a significant and growing portfolio of flexible generation (including new OCGTs and batteries, a large portfolio of pumped storage, and hydro) and is well positioned to capitalise on DS3 revenues, which thus enhances its competitive position in the energy market.

Consequently, there is a compelling case to retain the ESB ring-fence, and indeed strengthen it, in the absence of meaningful divestments. Removal of the ESB ring-fence would be counter to consumer interests in Ireland and Northern Ireland and counter to the objective of delivering a more competitive market.

(Please see Energia's response to SEM-16-030 where the economic, legal and procedural issues with removal of ESB ring-fencing are set out in more detail.)

[5] See pages 14-15 of Energia's response to SEM-16-030 for further details.

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.

Energia response:

The Directed Contracts mechanism should clearly continue in its current form as a tool to mitigate market power in the SEM given that ESB remains the sole dominant player in the all-island market with a large diverse portfolio of generation and a relatively balanced generation and supply business which mitigates its need to trade with other market participants. Directed Contracts also provide suppliers with a guaranteed opportunity to potentially avail of CfD Power hedges which they might otherwise struggle to access in other marketplaces (OTC/FTR auctions); provided that the Directed Contract pricing level is attractive to the supplier.

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?).

Energia response:

As explained in section 2 of this response, auctioning DCs would undermine the objective of the scheme and would be detrimental to retail competition and consumer interests, and so should not be considered[6]. The current DC pricing and allocation process should continue.

Whilst anomalies (or errors) in DC pricing can and sometimes do occur on rare occasions, this can be addressed on a case-by-case basis without resorting to an alternative methodology. One example is to carry out a review and validation of pricing when DCs do not sell. Another suggestion for minor change would be to update and release the DC coefficients closer to the subscription window to reduce the risk of coefficients becoming outdated due to market shocks.

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?

Energia response:

The Market Concentration Model for determining DC volumes is fit-for-purpose. There is no need to change it or to use an alternative approach. However, serious consideration should be given to reducing Electric Ireland's allocation of DCs to

[6] Moving from the current process to an auction-based platform (such as Tullet Prebon) would also bring additional transaction fees that participants will have to bear. This could put further strain on smaller participants, as these costs are not present in the current Directed Contracts process.

reflect its 'internal hedges' through legacy contracts with Synergen and Coolkeeragh and redistributing its DC allocations to other suppliers accordingly. This is justified on the basis of promoting competition, as discussed in response to question i above. It is also crucial to recognise that Electric Ireland's absorption of DCs negates the beneficial effect of these contracts on ESB's incentive to exercise market power in spot markets. As explained in section 2 of this response, this is because the price in a contract between ESB Generation and Electric Ireland is merely a transfer price with no implications for the profitability of the group as a whole. (This is true whether or not the two businesses are ring-fenced).]

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.).

Energia response:

As discussed in section 2 of this response, the evidence is clear that almost 100% of DCs made available are ultimately sold. Whilst eligibilities are not always consumed in the primary subscription windows by participants, 80% of the time the additional volume is picked up by other participants in the supplementary window. This suggests that participants value DCs differently, depending on their market expectations and valuation of / access to alternative options, which is what one would expect in any market.

<u>Forward Contracting & Liquidity</u>

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?

Energia response:

The SEM is a small, relatively isolated market with a high and growing penetration of renewables and one dominant player, ESB, with a relatively balanced portfolio of generation and supply. The SEM forward market is unlikely to evolve into a highly liquid market and any regulatory intervention designed to enforce forward liquidity for its own sake would be misguided and could harm competition. Instead, efforts should focus on promoting competition by arranging a transfer of hedging products from ESB to other suppliers (as suggested in response to question v above) and letting forward liquidity develop organically.

In the short term, the efforts of the Marex Spectron brokering service within the Irish market has provided something different and has allowed participants to broker deals with counterparties through 'sleeving' arrangements with a third party intermediary who has credit access to both transacting parties. This is something different that was not available through the Tullet Prebon service (or at least not availed off, if this service was available).

In the longer term, exchange based trading with centralised clearing could possibly help alleviate the credit burden for participants as there would only be one credit requirement with the exchange (clearing member) instead of multiple agreements with each trading party. However, exchange based trading should only be considered where there is an overall net benefit from introducing such arrangements – i.e. ensuring that any benefits are not offset by increased working capital requirements and / or higher trading fees. This was not the case, based on available information at the time, when exchange based trading was last considered by the SEM Committee in 2016[7]. It could however be reviewed again in future.

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?

Energia response:

There is always scope for natural growth and innovation in any market, which is driven by competition to meet customer requirements and facilitated by creative thinking and technology.

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?

Energia response:

In the event that the SEM Committee decide to intervene in the future, we would emphasise the following:

- The SEM forward market is unlikely to evolve into a highly liquid market and any regulatory intervention designed to enforce forward liquidity for its own sake would be misguided and could harm competition. Instead, efforts should focus on promoting competition by arranging a transfer of hedging products from ESB to other suppliers (as suggested in response to question v above) and letting forward liquidity develop organically.
- Effective mitigation of market power requires careful attention to the specific conditions of the individual market (i.e. its physical structure, ownership, market rules, etc.). This is particularly the case in the context of the SEM because of the continued presence of ESB as the large, legacy state-owned incumbent in relatively small retail and wholesale markets. Therefore, careful consideration is required to ensure that mitigation measures implemented are appropriate to address the specific nature of the market power issues that manifest themselves in the all-island context.
- Energia would encourage the RAs to put in place a robust monitoring and reporting framework on the health of the forward market, including of ESB-Generation's sale of forward contracts to Electric Ireland, as well as details on pricing levels, traded volumes, bid/ask spreads and so on.
- Price validation by an independent party after each DC round – if volumes do not sell during a DC round, investigation of the pricing levels should occur to

[7] See pages 14-15 of Energia's response to SEM-16-030 for further details.

ensure the pricing level was competitive – especially if volume has made it to the supplementary auction and not been picked up.