Market Power and Liquidity Discussion Paper (SEM-20-045)

Power NI's Response

28th August 2020

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Introduction and Summary Position

Power NI welcomes the opportunity to respond to the SEM Committee's Discussion Paper on Market Power and Liquidity (SEM-20-045). As the SEM Committee will be aware, Power NI was actively involved in the consultative process stage of the I-SEM project. Highlighting the vital importance of a functioning and liquid forward market in delivering tangible benefits to end consumer and underpinning retail competition was at the forefront of interactions and consultation responses at that time. The importance of this area to Power NI has not changed.

Power NI recognises this Discussion Paper was mandated per SEM-17-015 "Measures to Promote Liquidity in the I-SEM Forwards Market". That being the case though it is important that sound evidence forms the basis of all decisions and any potential changes.

Power NI understands why at this juncture the Regulatory Authorities (RAs) do not feel intervention in the forwards market is required. Letting the organic growth in this area continue to develop a pragmatic approach to take at this juncture. Power NI would however support additional transparency in terms of market liquidity and feel the RAs are best placed to provide this transparency.

In relation to the removal of barriers to entry, the harmonisation of Master Agreements was one such measure and Power NI agrees no additional intervention is required in this area. Power NI also supports the continuation of ESB's current ring-fencing arrangements. Any change to ESB's ring-fencing arrangements has the potential to have a detrimental impact on forward market liquidity and transparency whilst at the same time creating a market power risk in both the wholesale and retail markets.

Power NI does not feel a change is required to the current Directed Contract pricing and allocation process. Evidence in the form of very high levels of volumes subscribed would not support a change to the process. Any deviation away from administered pricing would also undermine the core objective of the Directed Contracts process i.e. mitigating ESB's market power and have other unintended consequences through its use as a market reference price methodology.

General Comments

The following section covers Power NI's responses to the specific areas outlined in the discussion paper.

Regulatory Intervention in the Forwards Market

As the RA's have, Power NI also welcomes the fact Marex Spectron have developed and launched a complementary route to market to that offered by Tullet Prebon. The fact that Tullet Prebon have indicated a potential move to utilise Trayport will also bring a further layer of consistency and standardisation to the market which also must be welcomed.

Whilst welcoming the above organic growth in routes to market, this in itself doesn't necessarily promote liquidity. The paper states "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." Although definitively providing optionality, there is no evidence to date that having two platforms and two routes to market has or will significantly improve liquidity.

There is an argument that a continuous platform may dilute liquidity further. Parallels can be drawn from the current intra-day trading design where intra-day auctions where built into the trading day to promote or focus liquidity for buyers and sellers. This was also the case in GB, where under the Secure and Promote scheme, morning and afternoon trading windows where introduced as a means of focusing liquidity. This may be something to consider in relation to the current I-SEM platforms and offerings.

It is Power NI's view that the only way to effectively ascertain whether liquidity in the forwards market is at an appropriate level and is facilitated by the new routes to market, is to measure and independently report on it. As it stands currently, market participants or potential new entrants to the forwards market have no visibility at a macro level as to what level of liquidity exists in the market.

Whilst understanding why the RA's feel that regulatory intervention is not required at this stage, Power NI would call on the RAs to independently provide the transparency referred to above. It is only in this way market participants can ascertain, following a suitable bedding in period, whether the organic growth in platforms has in fact resulted in an improvement in liquidity.

Harmonisation of Master Agreements

Power NI will typically look to endorse and support measures that promote liquidity in the I-SEM forwards market, the harmonisation of master agreements being one such measure. As was anticipated following the decision paper SEM-

17-083, once established as the contract underpinning Directed Contracts, the Financial Energy Master Agreement (FEMA) has become the contract of choice for all I-SEM CfDs, regardless of platform or route to market. To this extent, Power NI would concur with the RA's decision that regulatory intervention is not required at this stage.

Notwithstanding the comments above, the establishment of FEMA counterparties and the associated contractual interactions can be and typically is, a long process, particularly with regard to some of the more specific elements such as the Credit Support Annex (CSA). Power NI feels there is benefit in exploring the possibility of having a centrally cleared platform where participants effectively sign up to the 'exchange' to access liquidity. Power NI will continue to discuss this approach with the existing platform providers.

ESB's Ring-Fencing Arrangements

Power NI supports the SEMC's decision in relation to ESB's ring-fencing arrangements i.e. the current ring-fencing arrangements should be maintained. As with the comments above relating to liquidity and measuring the levels of liquidity, Power NI believes evidence-based decision making should be the foundation of robust regulatory best-practice. Following this best-practice, Power NI does not see any evidence presented in this paper that would suggest the ring-fencing of ESB should be removed.

In relation to transparency, again as per above, Power NI would call on the RA's to measure and report on ESB inter-business forward trades. Similar to providing market transparency and confidence regarding general market liquidity, this would provide market transparency and confidence in the context of the potential to exercise forward market power.

Directed Contracts Allocation Process

The SEMC in this discussion paper recognise Directed Contracts as being "a core pillar of the SEM market power mitigation strategy". Baring this in mind, any potential change to the Directed Contract mechanism or process needs to be carefully considered and thought through, including any unintended consequences.

Power NI notes the SEMC is minded to consult upon alternatives to the current pricing and allocation process for Directed Contracts. The reasoning for this cited in the paper is "ongoing concerns from market participants regarding the RAs pricing of Directed Contracts". Power NI would strongly be opposed to changing the process at this juncture and sees no evidence to support a change especially given from Q2-2018, 95% of volumes offered in all windows have been allocated over the initial and supplementary subscriptions. It is therefore unclear given such high levels of volumes are being taken the RAs would consider any change being deemed necessary.

Any deviation away from administered pricing would undermine the core objective of the Directed Contracts process i.e. mitigating ESB's market power. In a competitive auction process for example, there is nothing to stop Electric Ireland inflating prices to stifle competition to the benefit of the wider ESG Group. This also provides no disincentive to exercise market power as ESB sit on both sides of these trades.

Power NI would also have concerns in relation to any unintended consequences of changing the pricing and allocation process. For example, the Directed Contracts product prices are not only used to price products but also as reference prices in Mark-to-Market calculations and credit provisions, not only within Directed Contract FEMA's but in wider Non Directed FEMA's also. In the absence of a fully liquid forwards market, the Directed Contract pricing also provides something by way of a forward curve, which, without any other independent and transparent market publications on liquidity, is a pricing signal for potential new entrants.

As with any potential market change, the cost to end consumers must be recognised and mitigated. A change for example to an auction that uses the Directed Contract administered price as a reserve, is likely to clear in excess of this given the historically observed scarcity premium in auctions. This will have a detrimental impact on the price ultimately paid by end users.

The current process may not be perfect, for example the algorithm doesn't necessarily dynamically reflect significant changes in pricing fundamentals post model calibration. This however can be partially remedied by updating the co-efficients in advance of a subscription round. Issues like this however do not merit a fundamental change to the entire Directed Contracts subscription process.

For the reasons outlined above, and the timing (wider regulatory changes associated for example with Brexit or the Clean Energy Package), Power NI does not feel a consultation on the Directed Contracts pricing and allocation process is warranted.

Call for Evidence Questions

Within the Discussion Paper the SEMC asked a number of specific questions Below are Power NI's responses to the specific 'Call for Evidence' questions raised in the discussion paper:

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

Answer: Assuming this is referring to the forwards market, market access is helped by harmonisation such as that provided by the industry standard FEMA or common trading platforms. Further accessibility could be gained if platforms are developed to centrally clear trades and if forward liquidity was measured and independently reported on.

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.

Answer: Power NI agrees with the SEMC's approach regarding ESB's current ring-fencing arrangements for the reasons outlined above.

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.

Answer: Power NI strongly believed that the SEMC should continue to use Directed Contracts and considers there to be no basis to support a change as evidenced by consistently high levels of Directed Contract volumes subscribed to.

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?).

Answer: Power NI strongly believes, for the reasons outlined in the above response, administered pricing is the only way to ensure market power mitigation is maintained.

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?

Answer: The HHI indicator described in SEM-17-064 is an industry recognised tool to measure market concentration and Power NI sees no evidence to support a change at this stage.

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.).

Answer: Every market participant will have their own hedging strategy which amongst other things will depend on their retail product offerings and internal risk appetite. For example, an energy pass-through retail product does not require a hedge therefore Directed Contract volume would not be required to hedge customers on this tariff. Participants may also have their own views on forward prices which can differ from Directed Contracts pricing.

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?

Answer: As mentioned previously Power NI understands and supports no regulatory intervention at this stage in the forwards market. With multiple routes to market, harmonised master agreements and the continuation of ESB ring-fencing, time is required to let the market organically develop and to assess if in particular, the additional route to market does improve liquidity. To properly make this assessment Power NI feel transparency on what market liquidity levels exist would be helpful.

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?

Answer: As described in vi above, hedging in SEM will ultimately be driven by the risks market participants face in operating in the market and internal risk appetites of those participants. As the market evolves, risks faced by participants (both suppliers and generators) will also evolve and it is important that the forward market remains fit for purpose in this backdrop. Any inefficiencies within the forward market will ultimately be picked up by end customers which must be at the forefront of policy or change decisions. In relation to renewable with a drive towards a 70% renewable target by 2030, a long-term view has to be taken on the opportunities/threats this presents to the forwards market.

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?

Answer: It is Power NI's view that market power mitigation should be the primary driver for regulatory intervention in the forwards market. A review point with similar timeframes from the new SEM arrangement go-live to this discussion paper may be prudent to assess the state of the forwards market at that time.

Conclusion

Power NI supports the position that no further regulatory intervention at this juncture is required in the forwards market itself, in relation to harmonised Master Agreements or in relation to ESB's ring-fencing arrangements. Power NI does not however support any changes to the current Directed Contract pricing or allocation process and feels a consultation in relation to this at this time is not required. Any deviation away from administered pricing would undermine the core objective of the Directed Contracts process i.e. mitigating ESB's market power and have significant unintended consequences.

Power NI has provided responses to the call for evidence questions, some of which are expanded upon within the wider response. If at any time the SEMC wish to engage regarding any of the points raised in this response, Power NI are happy to do so.