Amendment to the Allocation of Directed Contracts

Decision Paper

SEM-21-085

22 November 2021

EXECUTIVE SUMMARY

This Decision Paper, "*Amendment to the Allocation of Directed Contracts*" (SEM-21-085), sets out the SEM Committee's decision to continue with its amended approach for the allocation of Directed Contracts (DCs), which involves reallocating a limited volume of DCs to smaller suppliers in each DC round.

On the 13 August 2021, the SEM Committee published an Information and Consultation Paper: "*Amendment to the Allocation of Directed Contracts*" (SEM-21-065). To support small suppliers who have limited options to hedge wholesale electricity price exposures (relative to Vertically Integrated Utilities (VIUs) and larger utilities), and in the interests of promoting competition and protecting the consumer, the SEM Committee notified stakeholders that it would implement an immediate measure to reallocate a limited volume of DCs in Round 16. Additionally, the SEM Committee consulted as to whether this amendment should become an enduring arrangement, pending a conclusion of the broader market power and liquidity workstream.

Following the closure of the consultation window (13th September 2021), the Regulatory Authorities (CRU and UR) received a total of nine responses to the SEM Committee Information and Consultation Paper (SEM-21-065). The SEM Committee notes that respondents' comments varied, with small suppliers generally in favour of the SEM Committee's amendment to the DC allocation methodology, while VIUs were generally against the SEM Committee's proposed amended approach.

The SEM Committee notes that the respondents generally in favour were also of the view that the SEM Committee's amended approach should go further. Such respondents suggested that action should be taken by the SEM Committee to increase forward liquidity in the SEM (e.g. cease offering DCs to Electric Ireland and reduce DCs allocated to VIUs).

Respondents who disagreed with the SEM Committee's amended approach to DC allocations suggested, inter-alia, that the SEM Committee provided insufficient justification for the amendment to the DC allocation. Such respondents raised concerns regarding the regulatory governance/process of the SEM Committee's approach in implementing the amendment to DC allocations for Round 16. Additionally, some respondents suggested that DCs are potentially ineffective in mitigating market power in the SEM. Such respondents suggested that the volumes offered in DC rounds are not reflective of ESB generation plants' actual running hours and suggested that ESB's ring-fencing arrangements should be reviewed.

Following consideration of the consultation responses to SEM-21-065, the SEM Committee has decided that the amendment to the methodology of calculating DC allocations that took place during DC Round 16 will become an enduring arrangement, pending a conclusion of the broader market power and liquidity workstream.

Consequently, the SEM Committee will implement such amendments into the forthcoming DC Round 17, and subsequent rounds thereafter. The SEM Committee notes that other potential amendments to DC allocations and requests for reviews of market power and liquidity in the SEM (as suggested by respondents) were beyond the scope of the SEM-21-065 consultation paper. These will be considered accordingly by the SEM Committee in its review of market power and liquidity in the SEM.

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1. INTRODUCTION

In August 2021, the SEM Committee published an Information and Consultation Paper, "*Amendment to the Allocation of Directed Contracts*" (SEM-21-065). The purpose of this Decision Paper is to set out the SEM Committee's decision in relation to its proposals in SEM-21-065.

In SEM-21-065, the SEM Committee notified stakeholders in that it would implement an immediate measure to reallocate a limited volume of Directed Contracts (DCs) in Round 16. This was to support small suppliers who have limited options to hedge wholesale electricity price exposures (relative to VIUs and larger utilities), while also being cognisant of the need to promote competition and ultimately protect the interests of the consumer (taking account of the recent developments in the wholesale power market). Additionally, the SEM Committee consulted as to whether this amendment should become an enduring arrangement, pending the conclusion of the broader market power and liquidity workstream.

In total, the SEM Committee's Information and Consultation Paper (SEM-21-065) received nine responses. Of the nine responses one was marked confidential. The SEM Committee notes that most of the issues raised in the confidential response were similar to those in the non-confidential responses, and the SEM Committee has not relied on any evidence presented in the confidential response that is not available to all stakeholders.

Table 1 below lists respondents who have provided publicly available responses, which can be obtained from the SEM Committee website.

Bord Gais Energy	Panda Power
Bright Energy Supply	Power NI
Energia	PrepayPower
Flogas/Budget	SSE Airtricity

Table 1: List of Respondents to SEM-21-065

Following consideration of all responses received, the SEM Committee is hereby setting out its decision regarding whether its Round 16 DC amendment should become an enduring amendment to the existing DC Eligibility model, pending the conclusion of the broader market power and liquidity workstream.

1.1 STRUCTURE OF PAPER

- Section 1: Introduction;

- Section 2: Provides background to the "*Amendment to the Allocation of Directed Contracts Information and Consultation Paper*" (SEM-21-065);

- Section 3: Summarises the responses to the Information and Consultation Paper (SEM-21-065), and details the SEM Committee's associated response; and

- Section 4: Sets out the SEM Committee's decision and next steps.

2. BACKGROUND TO INFORMATION & CONSULTATION PAPER SEM-21-065

In July 2020, the SEM Committee commenced a review of market power and liquidity in the Single Electricity Market (SEM) by publishing a Market Power and Liquidity Discussion Paper (SEM-20-045) to inform market participants of the SEM Committee's intended approach to address four decisions within the 2017 Forwards and Liquidity Decision Paper (SEM-17-015). Additionally, in February 2021, the SEM Committee published a Market Power and Liquidity Information Paper (SEM-21-007).

While the review of market power and liquidity in the SEM is currently ongoing, the SEM Committee acknowledged in its August 2021 Information and Consultation Paper (SEM-21-065), that recent developments in the wholesale power market are limiting participants' access to forward hedges.

At the time of SEM-21-065's publication, developments impacting negatively on forward liquidity included:

- An increased number of planned outages of thermal generators, which reduced generation capacity and contributed to a rise in the wholesale price of electricity;
- A decline in the availability of Directed Contract (DC) volumes over recent DC rounds with a shift towards reduced baseload products and a greater share of mid-merit products;
- Public Service Obligation Contracts for Difference (CfDs) have not been available since 2019;
- Since January 2021, Interconnector Financial Transmission Rights (FTRs) are also no longer available; and
- Clean spark spreads trending upwards since January 2021[1].

[1] The clean spark spread represents the theoretical net revenue of a gas-fired generator having deducted the cost of fuel and emissions. It is measured as: the wholesale price of electricity minus the price of natural gas and the cost of carbon credits, taking into account the fuel efficiency of natural gas in producing electricity. The following efficiency inputs are used to calculate Baseload CCGT Clean Spark Spreads: Therms/MWhE(gas) = 69.541. Gas Emissions Intensity Factor: tCO2/MWhE(gas) = 0.411.

The SEM Committee also noted within its Information and Consultation Paper (SEM-21-065), that the current market environment may have a greater impact on smaller suppliers operating in the electricity retail market, as they have limited options to hedge such exposures in contrast to VIUs and larger suppliers. To support smaller suppliers, promote competition and ultimately protect the interests of consumers, the SEM Committee implemented an immediate amendment to the DC eligibility model for DC Round 16.

For DC Round 16, the SEM Committee removed DC volumes normally allocated to eligible companies who do not have a DC Financial Energy Master Agreement (FEMA) in place with ESB Power Generation, such that they cannot participate in the DC round. These DC volumes were reallocated to suppliers with a with a Maximum Import Capacity (MIC) value less than 5% of the total market MIC.

In SEM-21-065, the SEM Committee noted that this amendment does not impact on the DC eligibilities for larger suppliers in the DC Primary Subscription Window, however, the amendment may reduce the potential DC volumes available to such suppliers in the DC Supplemental Subscription Window. Furthermore, the SEM Committee noted that the proposed amendment will result in the redistribution of an additional 3% (approximately) of DC volumes to smaller suppliers (with an MIC less than 5% of the total market MIC).

As part of SEM-21-065, the SEM Committee consulted with stakeholders on whether the amendment to the DC Eligibility Model, as implemented as an immediate measure in Round 16, should become an enduring arrangement, pending the conclusion of the broader market power and liquidity workstream.

3. SUMMARY OF RESPONSES TO SEM-21-065 & SEM COMMITTEE'S RESPONSE

3.1 SUMMARY OF RESPONSES RECEIVED

The SEM Committee notes that respondents' comments were varied, with small suppliers generally in favour of the SEM Committees amendment to the DC allocation, while VIUs were generally against the SEM Committee's amended approach.

Respondents in favour of the proposed amendment to the DC allocation, noted, inter-alia:

- The change put forward by the SEM Committee to increase DC availability to smaller suppliers, while welcomed, will have a minimal effect in terms of increasing forward liquidity for smaller suppliers. Some respondents noted that if all suppliers executed DC FEMAs with ESB, the SEM Committee's amendment would be negligible;

- The current DC allocation process has bias towards VIUs and larger suppliers, creating a barrier to entry for smaller suppliers, which is not in the interest of consumers;

- There should be an increase in the DC allocation to smaller suppliers through various amendments including:

    - not allowing Electric Ireland access to DCs; or
    - including all ESB generation in the DC volume calculations; or
    - allocating DC volumes to suppliers based on their net volume position (metered sales volumes less generation volumes); or
    - allocating 50% of DCs equally amongst all suppliers, and the remaining 50% pro-rated on sales volumes.

- There is potential for the SEM Committee and the Regulatory Authorities (RAs) to be unduly influenced by VIUs and large market participants, and that a full review of market power and liquidity should be undertaken. Furthermore, some respondents raised concerns that the SEM forward market is dysfunctional and that market power arrangements in the SEM (e.g. DCs & ring-fencing) are not effective.

Respondents disagreeing with the SEM Committee's implementation of the proposed amendment on an enduring basis noted, inter-alia:

- Concerns regarding perceived lack of consultation involved in amending R16 DC volumes, and insufficient justification/rationale provided by the SEM Committee for implementing the immediate amendment for DC Round 16;

- The impacts of the SEM Committee's decision to amend Round 16 volumes were not fully considered;

- The cost of hedging is unnecessarily high, which is impacting suppliers' ability to hedge;

- The volume of DCs being offered by ESB is not reflective of the increased running hours of ESB's generation units during periods of large sparks, suggesting a method of rectifying any under-forecast in the volumes of DCs offered by ESB is required;

  One respondent proposed that if ESB generation runs at a certain percentage above that forecasted by the RAs, then ESB would be required through ex-post reconciliation to pay back to the market any monies earned on uncontracted volumes on relevant DC products that would not have been earned were they required to be contracted to mitigate market power;

- DCs and current ring-fencing arrangements for ESB are not working effectively as a market power mitigation tool. One respondent suggested an approach to overcome such concerns is to not allocate DCs to Electric Ireland or not to count the portion of DCs allocated to Electric Ireland in the HHI calculation; and

- The need for the RAs to provide additional insights on the results of their DC concentration model, and to explore why some suppliers are not entering FEMAs.

3.2 SEM COMMITTEE RESPONSE

The SEM Committee notes that respondents had divergent views regarding the merits of implementing the amendment to the DC eligibility model as an enduring arrangement, and that many of the proposals (e.g. limit DCs allocated to Electric Ireland & other VIUs, allocate DCs equally to all suppliers) put forward by market participants were beyond the scope of the consultation paper.

Amendments to the Allocation of DCs

With reference to respondents' requests for the SEM Committee to make amendments as to how DC volumes are determined via the DC Concentration Model and allocated via the DC Eligibility Model, the SEM Committee notes its position is not to make any significant amendments (assuming warranted) until its review of market power and liquidity in the SEM concludes. Notwithstanding, the SEM Committee will continue to review and update, where appropriate, its DC models (including the DC concentration model) to ensure that it provides a reasonable reflection of market conditions (e.g. new interconnections), and that the DC volume obligations on ESB provide a reasonable reflection of its market share.

Impact of R16 Amendment

The SEM Committee notes some respondents' comments that the R16 amendment should go further, and that if all suppliers executed DC FEMAs with ESB, the SEM Committee's amendment would be obsolete. Nevertheless, the SEM Committee is of the view that the action taken for DC R16 is proportionate and fair, given that its review of market power and liquidity is ongoing.

The SEM Committee further notes comments it had not fully considered the impacts of its R16 DC decision, and that VIUs are also experiencing similar issues to smaller suppliers in terms of accessing forward hedging product. The SEM Committee disagrees with suggestions that it had not considered relevant impacts, and notes that VIUs and large suppliers are unaffected by this measure in terms of their DC eligibilities in the DC Primary Subscription Window. Additionally, the SEM Committee is of the view that the issue of accessing forward hedges is more acute for smaller suppliers relative to VIUs (who have access to internal hedges).

Influence by VIUs

The SEM Committee rejects suggestions of undue influence by VIUs and large market participants. When carrying out its relevant functions in relation to the SEM, the SEM Committee's principal objective is to protect the interests of consumers of electricity in Ireland and in Northern Ireland, wherever appropriate, by promoting effective competition between persons engaged in, or in commercial activities connected with, the sale or purchase of electricity. When making decisions, the SEM Committee follows due regulatory process, and endeavours to ensure its decisions are based on necessity, proportionality, non-discrimination, transparency and consistency.

SEM Forward Market

The SEM Committee notes respondents' concerns regarding the lack of liquidity in the SEM forward market, and its impact on market competition. While cognisant of respondents' concerns, the SEM Committee's current approach is to let the forward market develop organically, while monitoring how it develops by gathering data from relevant market participants. The SEM Committee notes that the issue of barriers to entry (through lack of forward product) will be considered accordingly in its review of market power and liquidity.

Concerns over SEM Committee's Engagement on Amendment to DC Round 16

The SEM Committee notes comments received from market participants regarding the perceived lack of consultation in implementing the immediate amendment to the DC Eligibility Model for DC Round 16. Taking account of recent market developments, and market participants' previous responses to its market power & liquidity papers, the SEM Committee is of the view that its decision was based on necessity, while being proportionate, non-discriminatory, transparent and consistent. Additionally, the SEM Committee notes the importance of agility in making decisions that protect the interests of consumers.

Effectiveness of DCs and Ring-fencing as a Market Power Mitigation Measure

The SEM Committee notes respondents' comments regarding DCs and ring-fencing. The SEM Committee will consider these issues as appropriate in its review of market power and liquidity.

4 SEM COMMITTEE’S DECISION & NEXT STEPS

Having considered responses received, the SEM Committee has decided that the amendment to DC R16 (as outlined in SEM-21-065), will apply for DC R17 (December 2021) and subsequent DC rounds, pending a conclusion of the broader market power and liquidity workstream.

The SEM Committee will continue to monitor the impacts of this decision and consider other potential changes to its DC models (e.g. DC Concentration Model and DC Eligibility Model) to ensure it reflects developments within the market. Furthermore, the SEM Committee will continue to monitor market developments and consider options to provide access to hedging products to all or a subset of suppliers, if deemed warranted and in the interests of protecting the consumer.