Market Modelling Group
Commission for Regulation of Utilities
The Exchange
Belgard Square North
Tallaght
Dublin 24
mmg@cru.ie

13th September 2021

RE: Amendment to the Allocation of Directed Contracts, Information & Consultation Paper, SEM-21-065

Dear Market Modelling Group,

Bord Gáis Energy (**BGE**) welcomes the opportunity to respond to this Information and Consultation paper (the '**paper'**) regarding whether the proposed amendment to the DC Eligibility model should be an enduring arrangement.

In BGE's view, this paper brings into clear focus three particular issues in the SEM at present:

i. The lack of forwards liquidity in SEM is exacerbating the problem that suppliers are facing today. We understand and empathise with the challenges being experienced by suppliers in the market and the SEM Committee's desire to alleviate these. The increased commodity prices and sparks being seen in the market are putting extraordinary pressure on suppliers which highlights the problem of a lack of forwards liquidity. The matter of insufficient forwards liquidity is however a growing issue which will worsen as an increased level of renewables comes onto the system and thermal generation running declines this decade. The current interim solution outlined in this paper is only a short-term fix and in our view the enduring solution should be one which addresses the root of the problem and improves liquidity for the benefit of all suppliers and ultimately all end-consumers. Addressing the root of the problem in our view includes examining the role of market power in limiting forwards liquidity and mitigating the scope of that issue. We expand on this point further, including possible solutions, in point 1 below.
ii. We recognise that there is inherent difficulty in forecasting the future running of generation units but the intent of DCs in mitigating market power is being undermined by increased ESB generation units' running which needs review in our view. The volume of DCs being offered by ESB is not reflective of the increased running of ESB's generation units during periods of large sparks. This is a major problem for all suppliers. The intent of DCs is to mitigate market power such that with every DC that is sold, ESB's market power in the day ahead market is reduced until in theory it cannot or has no incentive to exploit its dominant position. Our analysis shows that ESB units experienced a significant increase in running over the course of H1 2021. The volumes of DCs however offered in DC rounds for the H1 2021 time period, and those on offer for the H1 2022 time period are not reflective of the increased running or sufficient in our view to ensure that ESB did not and does not have the ability and incentive to increase prices when certain generation volumes have not been contracted through DCs. There are transparent and fair ways of rectifying this however such that ESB does not have the ability or incentive to price up to benefit from generation volumes that should have been but were not contracted via DCs. We expand on this issue, and possible solutions, in point 2 below.
iii. The cost of hedging with ESB is unnecessarily high which is impacting suppliers' ability to hedge with ESB and is likely a key reason why small suppliers have not entered FEMA contracts with ESB. DC prices also regularly outturn inconsistent with market forecasts which undermines the reliability of DC volumes as hedges. Please see point 3 below for more on this issue and possible solutions.

1. The need to address market power in an enduring solution to the lack of forwards liquidity

As outlined in the introductory point (i) above, the issues being experienced by smaller suppliers in SEM today which this paper seeks to address serve to highlight the impact of a lack of forwards liquidity in SEM. The current interim solution is however only a short-term fix as the forwards liquidity problem in SEM will only grow with an increasing level of renewables on the system. The enduring solution(s) to improving forwards liquidity ultimately need to work for all suppliers to enable better outcomes that benefit all end consumers.

One issue that needs to be addressed is the influence of market power in causing insufficient forwards liquidity in SEM. As outlined in some detail in BGE's response in August 2020 to the SEM-20-045 Market Power and

Liquidity Discussion Paper[1], there is strong evidence that ESB Generation and Trading is tacitly hedging with Electric Ireland which undermines the intent of DCs to mitigate market power and how DCs can play a role in forwards liquidity. In theory each DC sold, including DCs to Electric Ireland (**EI**), should reduce the ability and incentive of ESB to price up. However, when a DC is sold to EI it does not reduce ESB's incentive and ability to price up because EI and ESB are part of the same company. ESB can increase prices in the day ahead market and will have to be paid under DCs by EI as a supplier but on the upstream side ESB has earned the high price which on a company basis offsets any high price differences paid under DCs by Electric Ireland. All other suppliers outside of the ESB group do not have this benefit and so are at a disadvantage compared to EI. The impact of the higher cost of hedging on non-Electric Ireland suppliers is ultimately felt by end consumers. The actions suggested by BGE in our August 2020 response to mitigate this impact included requests for immediate reforms to DCs including:

a) To not allocate any DCs to Electric Ireland while keeping the same approach to volumes of DCs to be offered today to reduce ESB's dominance in the day-ahead market (BGE's preferred solution). The intent of DCs is that with every DC that is sold, ESB's market power in the day ahead market is reduced until in theory it cannot or has no incentive to exploit its dominant position. With every DC that is not sold to a supplier other than Electric Ireland, it does not reduce ESB's market power in the day-ahead market. The intent of DCs would be better met if Electric Ireland DCs were instead allocated proportionately amongst all non-Electric Ireland suppliers. Or
b) To not count the portion of DCs allocated to Electric Ireland (**EI**) in the HHI calculation, thereby increasing the volume of DCs available to suppliers other than EI. And
c) If (b) above persists, to not allow Electric Ireland to purchase volumes in the supplemental window of DC auctions as this enables them to buy up volumes not sold in the primary window preventing those volumes going into the next DC auction to the detriment of non-EI suppliers.

In parallel we believe that a thorough examination of the vertical ringfencing arrangements cross the ESB group is undertaken. Such an examination should assess how all their generation units (thermal and wind), as well as how Coolkeeragh and Synergen legacy contractual arrangements, are feeding into Electric Ireland's hedging strategy. The outcome of that assessment could inform the Regulatory Authorities (**RAs**) on solutions to liquidity including around improved DC allocation that could be applied on a universal basis across all non-Electric Ireland suppliers. Please see our response to SEM-20-045 for further insights on the above noted positions.

2. A method of rectifying any under-forecast in the volumes of DCs offered by ESB is required to ensure that the intent of Directed Contracts in mitigating the exercise of market power is achieved; high ESB generation running should also outturn in higher baseload and mid-merit product offers

As outlined in the introductory point (ii) above our analysis shows that on average across all hours of the day, so spanning the baseload and mid-merit product timelines, ESB's generation output increased considerably from Q1 2021 to Q2 2021. Over the course of the Directed Contract (DC) round offerings for Q1 2021 and Q2 2021, this increased running was not adequately reflected in the baseload and mid-merit volumes offered in our view. ESB would have had the ability and incentive to price up volumes of generation that were not contracted via DCs and earn profits at high sparks. Such ability and incentive to price up is contrary to the function of DCs. It can therefore be concluded that ESB generation's market power over the course of H1 2021 has not been sufficiently mitigated. Based on the DC volumes offered to date by ESB there is a strong risk the incentive of pricing high will not be fully mitigated in H1 2022 either. Methods of rectifying this risk with a view to removing the ability and incentive for ESB to price up in the market for uncontracted DC volumes need consideration in our view. One suggestion is to consider that when for example the DC offer volumes forecasting is incorrect, with the result that ESB generation runs at a certain percentage above that forecasted by the RAs, then the RAs would through an ex-post reconciliation require ESB to pay back to the market any monies earned on uncontracted volumes on relevant DC products that would not have been earned were those volumes required to be contracted to mitigate market power. This would help ensure that the intent of DCs, to mitigate the ability and incentive of increasing prices, is achieved.

We also need to see more baseload and mid-merit products in DC offerings. Recent increased generation running outcomes for ESB Generation and Trading are not being reflected for upcoming DC quarterly offerings. As it stands 335MW/ 124MW less of baseload/ mid-merit DCs were offered for Q1 2022 versus Q1 2021 and while one DC quarterly round remains to be decided for Q2 2022, 87MW/ 262MW less baseload/ mid-merit DCs have been offered to date versus volumes offered for Q2 2021. More baseload and mid-merit DC volumes on offer would better help non-Electric Ireland suppliers' hedging strategies. The SEMC's recent information

[1] BGE's response to SEM-20-045 is here: https://www.semcommittee.com/sites/semc/files/media-files/SEM-21-004%283%29%20BGE%20response%20to%20SEM-20-045.pdf

paper on Round 16 Directed Contracts[2] notes that "*the growing share of wind generation, increases in commodity prices, changes to scheduled outage profiles in 2022 and volumes previously sold have resulted in reduced baseload and mid-merit running hours for certain ESB plant*." BGE requests more insights on this rationale for why we are not seeing more baseload and mid-merit DC volumes materialising for Q1 2022-Q4 2022. Increases in commodity prices apply across the whole market so all else being equal should not heavily influence the volume ESB has to offer in DCs. We ask for publication of the assumptions the RAs used for determining that the wind generation growth was not in favour of ESB and the assumed impact of outages on ESB generation (wind and thermal) units' running profile in 2022. We urge the RAs to outline how upcoming DC offerings will account for the ongoing tight margin situation in SEM which will endure beyond 2022 and ESB's expected increased baseload/ mid-merit running as a result.

3. Addressing the cost of doing business with ESB can help mitigate the challenges suppliers face

All suppliers have an opportunity to enter a FEMA and on foot of that FEMA can choose to bid for DCs they are allocated. In our view, two possible reasons why FEMAs to allow access to ESB DCs are not being entered by these smaller suppliers are:

- Value in DC prices does not consistently materialise which leads some companies to choose to be exposed to spot market prices which is highly risky and costly. This risk in turn can lead to volatile wholesale prices feeding more into these suppliers' retail prices increasing costs for consumers. These negative consumer outcomes would be somewhat mitigated were these suppliers' prices hedged with DCs that were more consistently priced in line with market expectations.
- The cost of collateral to cover DC cost exposure is prohibitively high. There is a requirement for suppliers to enter separate FEMA contracts for DC and non-DC contracts when trading with ESB. Separate collateral arrangements for DCs and NDCs with ESB respectively are thus also required which increases costs of hedging for all non-ESB counterparties and could deter smaller parties entering such arrangements. This is a barrier to the use of a single less expensive collateral (e.g. a letter of credit) that would cover the DC and NDC liabilities/ exposures. Being permitted to use the same letter of credit for both NDCs and DCs would help reduce the cost of hedging and possibly make the option of entering a FEMA to hedge with DCs in case DC prices do outturn at more consistent prices, more attractive.

  We therefore ask the RAs to explore whether some suppliers are not entering FEMAs due to the reasons noted above and what steps could be taken to mitigate the risks they perceive. Mitigation could be achieved for example by enabling the same letter of credit or other collateral to be used by non-ESB counterparties to ESB to cover DC and non-DC exposures simultaneously. This mitigation measure should have equal effect for all sizes of suppliers for an equitable outcome that works for the benefit of all end consumers as opposed to possibly only a smaller cohort of end consumers.

Figure 1 in the current paper outlines average monthly clean spark spreads. In the interests of transparency and replication of the RAs' calculations we request more insights on the assumptions used by the regulators to determine the figures in this graph. For example, are the same unit efficiencies applied across all months? Are the €/MWh based off a marginal plant or what plants are used to determine the outturn prices?

Finally, we ask that consideration is given to the risk that this new (interim) rule could have the negative effect of undermining the DC volumes that a supplier can expect to be offered, should those suppliers with no FEMA contracts with ESB at present decide between future DC rounds to take up FEMA contracts. This could undermine the reliance by suppliers on hedging via DCs for offering fixed contracts to customers. Undermining the reliance from round to round on DC volumes highlights in our view another reason why the solution should only be very temporary in nature until an enduring solution to the inherent and growing problem of insufficient forwards liquidity is determined that applies to all suppliers and ultimately benefits all end-consumers.

In conclusion, the solution outlined in this paper should not apply on an enduring basis. We understand and empathise with the challenges being experienced by suppliers in SEM and this paper highlights the major issue of insufficient forwards liquidity in SEM and its negative impacts. The level of increased renewables expected to come on the system this decade as well as the persisting market power concern in SEM exacerbate the forwards liquidity problem. Enduring solutions to this growing liquidity issue are needed that apply to all suppliers such that all end consumers as opposed to a smaller cohort of consumers will benefit for the longer term. One potential solution is to stop allocating DCs to Electric Ireland (EI) given the benefit EI has over other suppliers by virtue of the fact that high prices paid under DCs by EI are offset by high prices earned by ESB generation, as EI and ESB generation are part of the same company. Electric Ireland DCs should then be re-

[2] https://www.semcommittee.com/sites/semc/files/media-files/SEM-21-072%20Information%20Paper%20I-SEM%20R16%20-%20DC%20Quantities%20and%20Prices.pdf

allocated amongst all non-EI suppliers. The quantum of DC products on offer in H1 2021 and 2022 is also in our view misaligned with the increased running we saw in H1 2021 from ESB generation. To ensure the intent of DCs is retained an ex-post reconciliation whereby for example ESB pays back any monies earned on generation volumes that were incorrectly not contracted via DCs should be considered as outlined in point 2 above. The RAs' view on the quantum of baseload and mid-merit products and the ongoing decline in the volumes being offered is also sought, again in light of the increased baseload and mid-merit running seen across ESB generation units recently, which running can be expected to continue during the ongoing security of supply problem. BGE also believes that the cost for all non-Electric Ireland suppliers of trading with ESB could be reduced by allowing suppliers use the same letter of credit/ collateral to cover both DC and non-DC exposures as it is costly for all non-EI suppliers to hold separate methods of collateral for DCs and non-DCs respectively.

I hope you find the above comments and suggestions helpful. Please do not hesitate to contact me should you have any queries or wish to discuss any aspect above in further detail.

Yours faithfully,

Julie-Anne Hannon
Regulatory Affairs – Commercial
Bord Gáis Energy

{By email}