



Panda Power response to SEM Committee Consultation SEM-21-065

9th September 2021

We welcome the SEM Committees recognition of the current liquidity issues in the forward market, the particularly adverse impact on smaller suppliers and the necessity to take action to help ameliorate these adverse impacts. We agree that a change to the current system of allocating Directed Contract volumes is long overdue, required to provide a more level playing pitch for smaller suppliers and in the public interest.

Unfortunately, the action taken and/or planned by the SEM Committee is minimalist in approach, constitutes a minor tweak to the existing Directed Contract Allocation Methodology and fails to address the core problems in any meaningful way. Indeed, if all suppliers put DC agreements in place with the ESB, the SEM Committees proposed solution to this very serious matter is equivalent to doing nothing.

Having identified the need to allocate more DC volumes to smaller suppliers, who do not enjoy all the benefits of vertical integration we call on the Regulatory Authorities to make a meaningful change. There is a real opportunity here to do the right thing, support smaller suppliers who are disadvantaged by the current regulatory environment, improve competition in the market and thereby act in the interests of customers.

We note that the Directed Contract volumes available under Round 16, and as communicated on the 8th September 2021 (SEM-21-072) appear to have collapsed. Suppliers require additional information so that we can understand exactly what is happening. The SEM Committee need to assess the impact on Directed Volumes going forward and provide transparency to market participants. Clearly if directed contract volumes are falling this is another serious negative for small suppliers.

Having a liquid forward market is essential to meet the needs of customers and ensure a competitive market. The current failures in the forward market which have been well documented in earlier SEM consultations result in higher customer prices and reduced competition. At present the Regulatory Authorities are fully focused on ensuring an efficient and effective spot wholesale market (SEM) but there is little attention paid to prices prevailing in the forward market.

The forward power market in Ireland is neither efficient nor effective. Prices are higher than would exist in an efficient market and hence the end customers are paying more for their electricity.

The failures in the forward market were recognized by the RA's (Regulatory Authorities) as far back as June 2016, reference the SEM Consultation Paper SEM-16-030.

As the Committee will be aware through its various Discussion Papers and Consultations over the last five years there has been and is a significant issue with a lack of liquidity in the forward market. This lack of liquidity manifests itself both in 'volume' and 'price' terms. In its Consultation Paper SEM-16-030 entitled "Measures to promote liquidity in the I-Sem forward market" issued on the 17th of June 2016 the Committee confirmed that there was a serious lack of liquidity in the forward market and the consequences were as follows:

- An impediment to non-vertically integrated suppliers managing their risk.
- Reduced competition
- A hindrance on the ability of new market entrants to grow their market share.
- Results in higher prices to consumers.

Having regard to the above and other factors the SEM Committee concluded that a regulatory intervention was required.

It is most regrettable that despite the above conclusion no positive action has been taken on the core issue and instead we now mired in a further review which will extend to the end of 2021. This means that after a period of five years we are still discussing the regulatory changes which were identified as appropriate back in 2016.

The consequences of this include:

- Higher prices for customers
- Reduced competition in the Retail Market
- Significant impediments to newer market entrants gaining market share
- Newer entrants being forced to carry excessive trading risk
- A threat to the ability of smaller suppliers continuing in the market

Due mainly to a forced inability to hedge economically one new entrant withdrew from the market in 2019.

The failure of the Regulatory Authorities to act on this issue poses serious concerns regarding the possibility of 'Regulatory Capture'. One could conclude that the Large Vertically Integrated Suppliers have undue influence with the Regulatory Authorities.

Recent Market Developments

The SEM Committee notes the following in its current consultation :

Whilst the review of market power and liquidity in the SEM is currently ongoing, the SEM Committee notes that there are recent developments in the wholesale power market, which are limiting market participants access to forward hedges.

Developments impacting negatively on forward liquidity include the following:

- An increased number of planned outages of thermal generators has reduced generation capacity and contributed to an increase in the wholesale price of electricity;
- A decline in the availability of Directed Contracts (DCs) volumes over recent DC rounds with a shift towards reduced baseload products and a greater share of mid-merit products;
- Public Service Obligation (PSO) Contracts for Difference (CfD's) are no longer available¹;
- Interconnector Financial Transmission Rights (FTR's) are no longer available to interested parties since 1st January 2021; and
- Clean spark spreads have trended upwards since January 2021.



On top of the above and partly in consequence of the thermal outage situation we now have a situation where liquidity in forward power markets has deteriorated further. Very little volume is available to hedge and where it is offered the hedge premia have at least doubled (presumably reflecting the pricing uncertainty arising from the thermal outages) and are totally uneconomic. In addition, any gas proxy hedges which are in place are not effective as the increase in the spark spread is not hedged. Non vertically integrated suppliers rely on gas proxy hedges to a greater extent relative to vertically integrated suppliers as they do not have the benefit of the internal hedge between generation and supply.

Non vertically integrated suppliers are now experiencing the 'Perfect Storm' arising from the thermal outage situation combined with the liquidity problems arising from the SEM Committees decisions to postpone any regulatory intervention in the forward market. We are extremely disappointed that we find ourselves in such a financially disadvantaged position compared to the vertically integrated suppliers who dominate the market. The fact that Panda Power is effectively subsidizing large vertically integrated suppliers through the DAM price stack methodology is particularly galling. It is hard to imagine a more unlevel playing field.

The seriousness of these issues has compelled us to consider how our business can be financially sustained. As the forward market is now dysfunctional, we cannot effectively hedge our trading exposures at economic prices. This is a critical business situation for smaller suppliers like Panda Power.

We would emphasize that the additional difficulties which have manifest since January 2021 simply accentuate an already existing problem and add to what was already an unsustainable situation for smaller non-vertically integrated suppliers. The return of the Whitegate and Huntstown 2 Power Plants to operation will of course be welcome but will not deal with the fundamental liquidity issues.



Proposed Changes to Directed Contract Allocation Methodology

It is positive that the SEM Committee has recognized the problem, determined that smaller suppliers need support and acknowledged that it is in the Public Interest to amend the DC Allocation methodology.

The large vertically integrated suppliers are in a preferential position in terms of risk management (hedging) and pricing in that they:

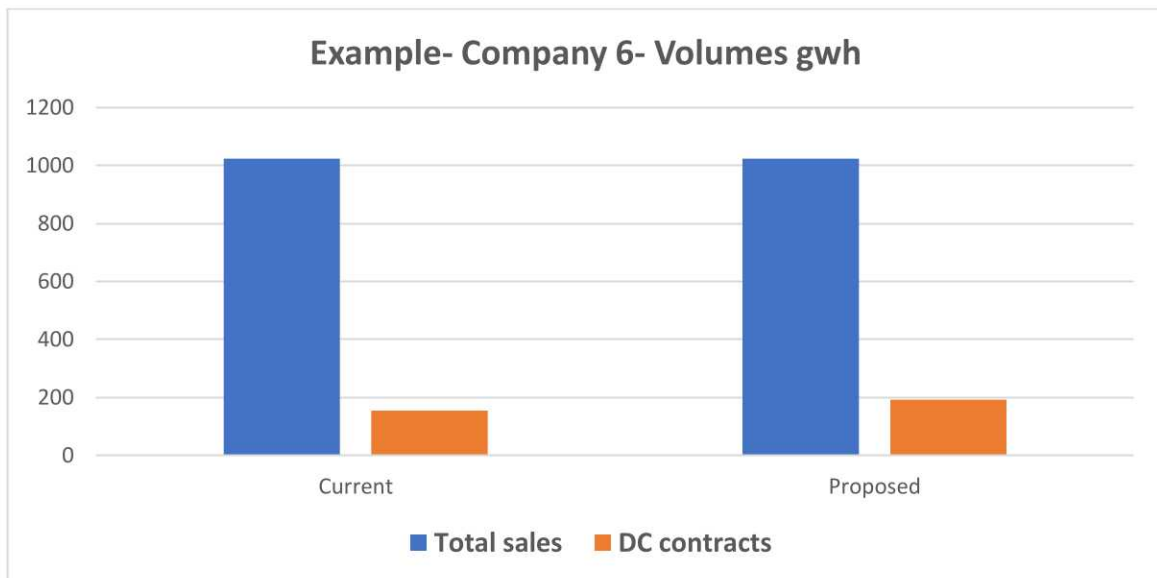
- Can hedge internally
- Retail arm does not have to pay the excessive risk premia demanded in the forward market
- Sole discretion in determining the price at which any volumes are offered in the Forward Market
- Generation arm receives the excessive risk premium where volume is offered
- Generation arm receives the highest marginal price in the SEM (to clear demand) where their bid is in merit
- Generation Arm receives capacity payments while being under no obligation to offer Forward Market prices to smaller players

The large vertically integrated suppliers are of course also gaining from the increase in spark spreads which the RA's have correctly identified.

Unfortunately, the action taken and/or planned by the SEM Committee is minimalist in approach, constitutes a minor tweak to the existing Directed Contract Allocation Methodology and fails to address the core problems in any meaningful way. Indeed, if all suppliers put DC agreements in place with the ESB, the SEM Committees proposed solution to this very serious matter is equivalent to doing nothing.

According to the Consultation paper the DC volumes allocated to suppliers who currently have no DC Agreement in place with the ESB amounts to 3% of the total DC volume. The average DC allocation to the small registered suppliers (6 to 10) amounts to 1.97% of the total available DC volumes. Allocating this extra 3% to the Small registered suppliers (Companies 6 to 11) results in the average allocation of 1.97% increasing to 2.48%. Clearly this is an extremely small increase.

We estimate that in 2020 DC volumes accounted for about 15% of total market volumes. This is based on 4,188 gwh of DC volumes are per SEM MMU Reports and a total market of 27,666 gwh as per 2020 CRU Retail Market Report. Therefore, under the existing DC Allocation methodology 15% of Small Suppliers volumes are covered by DC Contracts. Under the SEM Committees proposal this 15% figure increases to a maximum of 19%. Obviously while this constitutes a minor improvement in the suppliers hedging position it does not make a meaningful change to the risk management obstacles which suppliers face. Taking Company number six as an example the results of the SEM Committees proposal are as follows:



We note that 2 suppliers (who have no contract in place with the ESB) account for 2.05% of the total of 3%. One could reasonably expect these suppliers to put in place contracts with the ESB shortly.

So, under the present SEM Committee proposal one can envisage three possible outcomes:

1. The DC allocation to existing eligible Smaller Suppliers increases from the current average of 1.97% of total DC volumes to 2.48%, an increase of 0.51% of the DC volumes available
2. The two Suppliers mentioned above register and hence the allocation to the six small suppliers only increases by 0.16% each
3. All suppliers register and there is no change in the DC allocations to the six small suppliers

Assuming outcome 1 above the change in DC volume allocations would be as shown below



The above graph shows the best possible outcome. As detailed above the likely outcome is even worse and could amount to no change at all.

We believe that any reasonable person would regard the above changes are being close to meaningless and a hopelessly inadequate response to the disadvantaged position which smaller suppliers have been placed in by the continuing inaction of the Regulatory Authorities.

The SEM Committee has to date failed to implement either of the regulatory interventions which it identified as being appropriate as far back as 2016 which were:

- A market maker obligation (MMO)
- A Forward Contract Sale Obligation (FCSO)

In light, of the above and the further major deterioration in liquidity ('volume' and 'price') which has occurred since then a material change is required to the current system of allocating Directed Contracts. At present this would appear to be the only avenue easily available for addressing the concerns discussed above.

The Regulatory Authorities deemed it necessary to put in place the Directed Contracts obligation in order to mitigate the incentive for the ESB to engage in any abuse of market power in the SEM spot market. However due to its dominant position in the retail market approximately 35% of the DC volumes are then allocated back to the ESB. Clean spark spreads have increased considerably during 2021 with the level of generation held by the ESB a real concern. With the current inequalities in the market between vertically integrated and non-vertically integrated suppliers the practice of allocating back to the ESB 35% of the Directed Contract volume runs contrary to the stated objective of reducing market power.

The current uncertainty regarding the volume of directed contracts available going forward impacts on what changes would be fair and appropriate.

Based on 2020 Directed Contract volumes we are recommending that the Directed Contract Allocation Methodology be amended using one of the following approaches.

Option 1

- Given the dominance of the ESB across all facets of the market its retail arm should not be eligible for DC contracts.

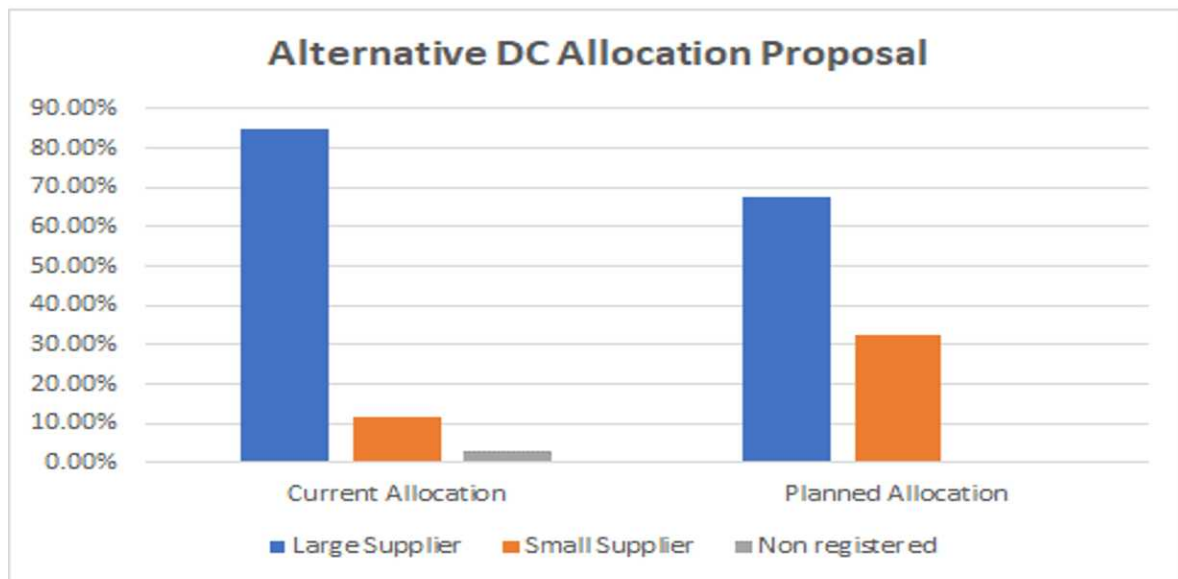
Option 2

- DC volumes allocated among all suppliers based on their 'Net' volume position. The 'Net' volume position of each supplier is calculated as total metered sales volumes less generation volumes (thermal and renewable). An appropriate reference period would be determined.
- Any volumes not taken up in Round one would fall into Round two as at present.

Option 3

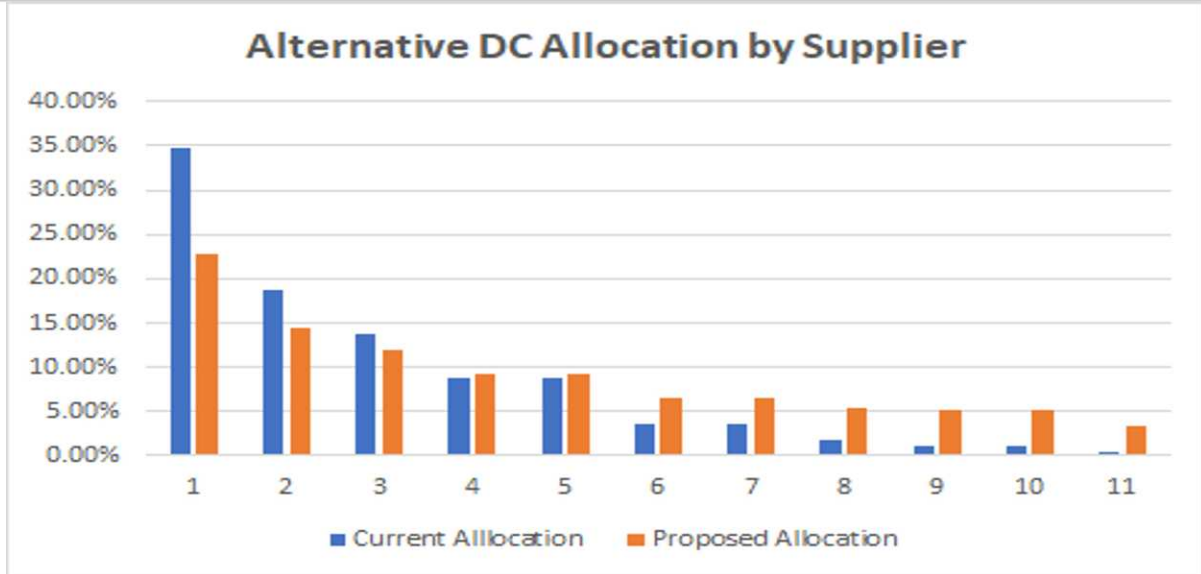
- 50% of DC volumes are allocated equally among suppliers (with the proviso that the DC volumes allocation cannot be greater than actual sales volumes), and the other 50% of DC volumes are allocated pro-rata on sales volumes, as at present
- Any volumes not taken up in Round one would fall into Round two as at present.

We do not have accurate data to model the results of Option 1. The results of adopting Option 2 would be as follows:



Hence based on the above suggestion the share of DC volumes which the Large vertically integrated suppliers receive reduces from 85% to 68% and the share which the Small Suppliers receives increases from 12% to 32%.

The results by Supplier would look as follows:



The above results appear balanced and meet the SEM Committees stated objectives of supporting smaller suppliers (who have more limited options to hedge), promote competition and protect the interests of consumers.

As previously detailed our assessment of the required changes in the directed contract allocation methodology is based on the volume of directed contracts sold in 2020 ie 4,188 gwh (approximately 15% of market volumes). However, based on SEM-21-072 it appears that the volume of directed contract volumes now available may be closer to 2,000 gwh. This is a critical issue and market participants require urgent transparency and clarity on the current situation and anticipated forward trends.

Should the volume of Directed Contracts be falling to such a low level it would be appropriate to agree that these very low levels of directed contract volumes would be used solely to support smaller suppliers who are currently disadvantaged compared to larger vertically integrated suppliers.

In this case all the directed contract volumes would be allocated to smaller suppliers, with 20% being split equally and 80% split on sales volumes, subject to any individual supplier's allocation not exceeding their sales volumes. This approach would have additional merit in that the ESB would no longer be required to support other similarly sized vertically integrated suppliers.



As detailed above and in previous submissions smaller suppliers face huge challenges in managing their trading risk at economic price levels and are significantly disadvantaged relative to the larger vertically integrated suppliers. It is clearly in the Public Interest that smaller suppliers be supported in their quest to remain in the market. As such it is incumbent upon the Regulatory Authorities to make a material change to the Directed Contract Allocation methodology.

The need to improve liquidity in the forward market by way of regulatory intervention was identified by the Regulatory Authorities five years ago. It is poor regulatory practice to identify the need for change and then do nothing about it. Unfortunately, the inaction can raise concerns relating to undue influence. It is understandable that our confidence in the Regulatory Authorities regarding this matter is at an extremely low ebb. We are calling upon the Regulatory Authority to make a material change in the basis for allocation DC volumes now and avoid further procrastination and delay.

