Response to Integrated Single Electricity Market (I-SEM)
Consultation on the
Forwards and Liquidity

SEM-15-011

On behalf of
AES Kilroot Power Ltd and AES Ballylumford Ltd

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Forwards and Liquidity

Introduction

AES welcomes the publication of the Integrated Single Electricity Market Forwards and Liquidity discussion document (SEM-15-010) and the opportunity to provide comments on the issues raised. AES would like to submit the following response to the Regulatory Authorities to their discussion paper.

AES is a global energy company with assets in the all island market consisting of coal and gas fired conventional and CCGT plant with additional distillate fired peaking gas turbine plant. AES is a non-vertically integrated independent generator which owns and operates Kilroot and Ballylumford power stations in Northern Ireland with a combination of merchant and contracted base load, mid merit and peaking plant. The responses to this consultation are therefore conditioned by the nature of our current position and portfolio of assets operating in the SEM.

Key Messages.

This response is submitted with reference to the level of detail that is currently available on the detailed design of the forward market and takes each of the sections of the discussion paper in sequence.

Within Zone Forward and Spot Market Liquidity

Lessons learned from SEM

Are there other issues which have affected forward liquidity in SEM or any comments on the applicability of the issues identified above? (In the paper).

- AES views that the collateral and credit levels required for forward (CfD, OTC) trading with counterparties could restrict opportunities for participants in the market and favours a common set of requirements applicable to all market and appropriate to the scale of trades and size of participant.
- Directed contracts (CfDs) offered by participants who have market power i.e. forced to offer volume and reference price set by RAs would aid liquidity in the forward market Previously SEM had no imbalance price exposure other than uninstructed imbalances so no significant incentive to manage imbalance risk exposure by trading in forward markets.
- Infrequency of trading – forward hedging auctions in the SEM are infrequent (every 2 weeks) and attract few participants, additional participant hosted auctions on an ad-hoc basis add to the liquidity of the forward market but volumes are small and opportunities limited. Access to other European exchanges if available would offer more opportunities.
- Which issues are expected to persist with introduction of I-SEM?
- Scheduling risk – i.e. a generators inability to determine its own schedule to be able to serve forward commitments due to central dispatch. The risk is potentially increased as all day ahead trading is carried out through the EUPHEMIA central European platform.
- The impact of the application of system constraints to the outcome from Euphemia presents additional scheduling risk requiring appropriate compensation for constraints

- Market concentration and vertical integration reduces incentive to contract on a forward basis as reduces the volume available to participate in the forward market. For example as stated in the discussion paper, ESB has a roughly equal generation/demand ratio and would be unlikely to trade in the forward market.
- Gas/Electricity price correlation – could persist depending on I-SEM bidding structures and rules still to be determined.
- Reduction in and uncertainty of CRM payment (RO) should incentivise forward trading to capture value.
- Wind forecast error – due to the relaxation of the original requirement for a mandatory day ahead market the incentive on wind generators to provide accurate forecasts and be balance responsible is reduced.
- What are the priority issues to address under I-SEM and what possible solutions should be considered?
- Relaxation of, or pooling of credit arrangements to cover different market time frames would reduce the costs
- Introduction of a clearing house.
- More frequent trading opportunities (greater than twice per month)
- Possibility of enforcing greater volume into the forward market (% of vertically integrated volume as per GB)

Specification/nature of forward products

- What forward products are expected to be needed under I-SEM?
- Within zone CfDs struck against the Day ahead market price – multiple products and duration, Base load, mid merit, Peak and for varying time scales, annual, quarterly, monthly. Shorter term products e.g. weekly may also be beneficial to market participants
- OTCs auction platform for varying durations and products as above.
- Access to wider European market platforms.
- Should development of appropriate products be left to the market or is specification from the RAs required?
- AES views a combination of both could be required, initially RAs should consult on and put in place products required and allow demand for additional or more flexible products to emerge.
- Depending on ability of conventional products to meet the requirements of the particular dynamics of I-SEM, demand for additional (flexible) products could emerge.

Nature of participation, including market participation obligations

- Is there a requirement for market maker arrangements? If so, what options should be considered?
- With emergence of some large vertically integrated companies, the even though some would be short in the market, the potential for significant volumes to be traded in the forwards market is low without some form of market maker obligation.
- Do we think there should be some form of mandatory participation for large or vertically integrated players and if so how much volume and who would be eligible.
- Is there a requirement for arrangements to facilitate small party access? If so, what options should be considered?
- Yes small participants should be provided with low costs and simple routes to access the forwards market. This could be achieved through contracting with suppliers or through generator aggregation.

Interactions with market power mitigation, including Directed Contracts

- What role should Directed Contracts play under I-SEM? What form should they take?
- Vertically integrated suppliers should be required to participate in the forward market with a maker type obligation to trade a percentage of their demand volume in the market. All eligible market participants should be able to compete for those volumes provided they have met the standard criteria for eligibility based on sufficient credit and collateral requirements.
- Are market power mitigation measures needed in the forward market? If so, what options are available and how could they be applied?
- Although the short term ex-ante markets are exclusive the forward market does not preclude large vertically integrated companies from trading bilaterally with themselves resulting in only net or small volumes being made available to other participants. This would seriously affect liquidity in the forward market and therefore some method of market maker obligation is going to be required, an example could be a form of self-supply restriction.
- AES supports measures to improve the availability of a range of longer-term products to support hedging of risk of exposure to large changes to prices and for these to be available on accessible trading platforms.

Mediums for trade and trading Institutions

- Is an I-SEM specific exchange or an I-SEM screen on an existing exchange preferable?
- Most participants are probably aware of and or have experience of the hosted OTC trade sites and would be familiar with their operation. An equivalent easy access web hosted site for forward trading would reduce forward market participant costs and allow ease of access to all participants. (An example would be the PRISMA site for gas auctions). An I-SEM screen on an existing exchange would probably be lower costs option than bespoke system for I-SEM.
- What conditions are needed to support effective functioning of an I-SEM exchange?
- A minimum number of participants and volume of trades are required to ensure and the operation of an exchange is financially viable. Reduced credit cover arrangements or pooling of credit cover and a reduction of costs across all market trades (such as fees) would incentivise participants to use an exchange and increase liquidity.
- Exchange based forward contract trading has the benefit to market participants of providing security and reduced trading costs with increased transparency over bilateral trading.

Factors affecting liquidity in the near-term markets

- Are there other issues which will affect liquidity in the near-term markets?
- Renewable generation participation in the ex-ante markets - The high level design decision resulting in the non-mandatory nature of DAM has created uncertainty with regard to the participation of renewable generation in the forward and near term markets which could impact confidence in the robustness of ex-ante prices.
- Energy Trading arrangements – the impact and application of the detailed design and market rules particularly with respect to the application of balance responsibility to renewable generation could have a significant effect on liquidity in the near term markets
- Demand side participation – the extent to which suppliers actively participate, providing variations in demand forecasts, and seek to balance their expected physical positions will also have an impact on liquidity. From the RLG meeting it became evident

that demand would not wish to submit forecasts and have to balance their positions in the near term markets, which seems to be at odds with the intent of balance responsibility in the HLD.

Cross Border Financial Instruments

Design of I-SEM Financial Transmission Rights

- What are the advantages and disadvantages of FTR Options or FTR Obligations? What is your preferred approach?
- As per the High level design only Cross border FTRs will be available (most of Europe still doing physical transmission rights with UIOSI). The design of the Interconnector FTR auction products should be such that participants are able to align with the proposed within zone products and match the market time frames, i.e. Annual, Quarterly, Monthly and Day ahead with intraday allocated implicitly.
- Assuming that the day ahead market price is used as the reference price for the forwards market and the uncertainty around the robustness of this based on the extent of the participation of renewables and demand side, the two way nature of the payment flows of FTR Obligations presents additional risk. AES therefore favours FTR options i.e. a one way CfD type arrangement.
- What measures need to be implemented to comply with financial regulation requirements?
- As FTRs are a financial transaction they may come under the MIFID and MIFID II requirements for financial transactions.
- Requirements seem to be placed on investment firms and market operators to organise so as to minimise conflicts of interests, impacts on product design and governance and impacts on the provision of market information which creates the potential for duplication and overlap with the REMIT and EMIR regulations.
- Commodity Market trades appear to be classified as "transactions" under MIFID II where they had previously been exempt. There is a real worry that without these exemptions, energy trading firms could end up being treated as de facto financial institutions, the practical effect being a re-categorisation that places additional financial regulation on companies.
- The risk therefore is that companies seen to be providing investment services, acting as a market-maker in commodity derivatives, or making use of algorithmic or high-frequency trading, might not qualify for exemption. The impact could be that companies hedging and risk management strategies will have to be revised.
- How should transmission losses be factored into FTR design?
- Losses should be accounted for by the interconnector owner and set as a price difference, equivalent to a tariff, creating a minimum price difference to be overcome and included in the settlement of FTRs. In this way losses procurement is implicit.

Allocation

- What are the I-SEM specific issues that need to be considered in development of Single Allocation Platform?
- The representation of the interconnectors between GB and I-SEM markets. AES favours the representation of the ISEM/GB boundary by 2 interconnector due to the different loss factors for the 2 interconnectors. This may create a problem for a regional or single allocation auction platform as the NC FCA states each bidding zone boundary to be

represented by only 1 interconnector but our understanding is that it may be possible to represent this with virtual areas.

- Should development of allocation arrangements be left to the market or is specification from the RAs required?
- AES views the design of any auction rules, facilities and allocation arrangements should be developed by the RAs and consulted upon with market participants prior to I-SEM go live. As the development of the single allocation platform is a future requirement, AES would envisage the development of a regional allocation platform initially progressing to the SAP when developed.
- For the trading of FTRs there is also a decision to be made on whether to set up a local I-SEM auction facility versus I-SEM page on a regional or pan European Exchange.

Firmness

- What are the I-SEM specific issues that need to be considered in consideration of firmness?
- The concept of the long term firmness deadline is new for the I-SEM. AES believes that the risk associated with the financial responsibility for compensation for curtailment beyond the long term firmness deadline, should rest with the interconnector owners, as similar to generators, those responsible for ensuring the availability of the interconnection should face the risk of non-availability.
- Should treatment of firmness issues be left to the market or is input from the RAs required?
- Whilst recognising that some of the decisions on this aspect have still to be taken at European level, AES believes that rules for the treatment of firmness before and after the day ahead firmness deadline should be developed by the RAs and consulted upon prior to I-SEM go live.

Revenue Adequacy

- What are the issues relating to revenue adequacy that need to be considered?
- As FTRs are financial transactions and can be traded separately in both directions, revenue adequacy will be determined by the reliability of the interconnectors, the uptake of FTRs and the amount of congestion income collected by the TSO based on the desire to trade between I-SEM and GB.
- Auction rules for determining reference and clearing prices should be developed by the RAs for consultation with industry participants.

Market Power

- What potential market power issues are linked to FTRs? How can they be dealt with?
- In theory the selection of FTRs was designed to reduce the potential for market power created by interconnector users holding physical transmission rights (PTRs) and subsequently locking out interconnector capacity and efficient energy flow by not nominating.
- The issue of an interconnector owner Eirgrid, being nominated as an interconnector TSO, the I-SEM TSO and also the market operator SEMO requires further consideration in relation to access to the interconnector capacity and other interactions with the markets.

Interaction with CfDs, Reliability Options and Renewable Certificates

- What interactions with other CfDs need to be considered in development of FTRs? What potential implications does FTR design have on these areas of interaction?

- If CfDs are conducted cross zonal this can only be facilitated with the additional acquisition of FTRs to ensure the access to the cross zonal interconnection capacity.
- It is likely that I-SEM market participants who wish to trade on the interconnectors will need to secure an RO to enable them to offset some of the long run cost and be competitive on price in the GB market.
- In SEM HLD capacity payments are made to generators exporting from GB to SEM via the interconnectors. In I-SEM unless they have secured an RO in the I-SEM RO auction they should not receive any capacity income.

Transitional Arrangements

- How should transition to FTRs be managed? What requirements are there during the transition phase?
- The transition should be managed by the development of set of FTR auction and secondary trading rules by the RAs, to be consulted on by industry and stating timescales for the first auctions to coincide with the start of the I-SEM in October 2017.
- Participants currently holding physical transmission rights may need to be grandfathered out resulting in a mix of arrangements for a transitional period. This could be accompanied by the PTR UIOSI rule in not already required.