



Response to SEM-15-010 I-SEM Discussion Paper on Forwards and Liquidity

Cenergise welcomes the opportunity to respond to the discussion paper in relation to the forwards and liquidity work stream of the integrated Single Electricity Market (I-SEM). Cenergise has extensive experience in the SEM and BETTA electricity markets and trades on both the Moyle and East-West interconnectors. We also offer consultancy and training services to the electricity and carbon sectors.

Currently the forward market in SEM is very illiquid. The main reasons for this are due to the high collateral requirements, scheduling uncertainty, limited products on offer and infrequent auctions. This must be addressed in the I-SEM.

Another key concern in I-SEM is the interaction of the Capacity Remuneration Mechanism with the forward market. A generator that sells both a 2-way CfD and a reliability option is exposed in the periods where the CfD reference price is above the strike price of the reliability option. This can be mitigated by capping the 2-way CfD at the strike price of the reliability option, but this will involve restructuring the Master Contract for Difference Agreements. However not all contracts sold at the CfD auctions may have a reliability option associated with them.

It is suggested that more CfD products are offered in I-SEM in order for suppliers to hedge their demand profiles and that market maker obligations are implemented. One of the key issues with the current market is the high collateral requirements. It is suggested that a clearing house or exchange is introduced to reduce the collateral requirements for forward trading. However the costs associated with this must be minimised.

FTR Options are the preferred approach for cross border trading. It is suggested that transmissions losses are interconnector specific to ensure that Moyle is not subsidising the East West Interconnector or future interconnectors. There also needs to be more clarity on how market participants will transition from the current SEM to the new I-SEM.

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Below is our response to the specific questions posed in the discussion paper:

1. 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?***

There are four main issues which have affected liquidity in the forward market in SEM:

1. High collateral requirements. Most sellers initially require collateral to cover 15% of the underlying value of the contract.
2. Due to scheduling uncertainty, sellers are reluctant to sell forward CfDs in the event that their plant doesn't get scheduled, particularly peak products. The majority of the peak products that have been sold to date are at the DCs, which were instructed by the CER.
3. There are only four CfD products on offer: Baseload, Mid Merit, Mid Merit 2 and Peak. While they do provide a hedging mechanism for suppliers, there is a need for more CfD products to match suppliers demand profiles.
4. The OTC auctions, which are the most frequent auctions, are held only twice monthly. There is also currently no secondary market. This creates an illiquid market.

- ***Which issues are expected to persist with the introduction of I-SEM?***

1. It is hoped that the collateral requirements for trading CfDs will decrease in the I-SEM. The introduction of a clearing house or exchange will reduce the collateral requirements for forward trading. This allows suppliers to post collateral with one central counterparty, instead of several.
2. The scheduling uncertainty should reduce in the I-SEM as there is a relaxation of the SMRC bidding, however there is still scheduling uncertainty as plants cannot self-dispatch.
3. The chosen CRM, reliability options, will also have an impact on the forward market. Currently in the forward market, contracts are sold as 2-way CfDs. A generator that sells both a 2-way CfD and a reliability option is exposed in the periods where the CfD reference price is above the strike price of the reliability option. This can be mitigated by capping the 2-way CfD at the strike price of the reliability option, but this will involve restructuring the Master Contract for Difference Agreements. However not all contracts sold at the CfD auctions may have a reliability option associated with them.

- ***What are the priority issues to address under I-SEM and what possible solutions should be considered?***

The primary issues to address in the I-SEM include:

- Interaction of the reliability options with the forward market
- Collateral requirements – implementation of a central clearing house for forward trading.
- Mandating larger players to offer CfDs in the forward market to ensure sufficient liquidity

2. Specification / nature of forward products

- ***What forward products are expected to be needed under I-SEM?***

The forward market gives supply companies an opportunity to lock-in a fixed price for electricity. Therefore the supply companies should specify their requirement for products.

- ***Should development of appropriate products be left to the market or is specification from the RAs required?***

The development of the appropriate products should be specified by the RAs, after consultation with market participants.

Generators that sell CfDs do not have the same requirements as suppliers. Therefore companies with a large market share can decide to offer limited products to market. This leaves small independent suppliers exposed. Therefore the products should be specified between industry and the RAs.

3. Nature of participation, including market participation obligations

- ***Is there a requirement for market maker arrangements? If so, what options should be considered?***

Yes there is a requirement for market maker arrangements. In 2013, over 26% of the publically traded forward market consisted of DCs, which are directed by the CER. It is suggested that market participants above a defined market share are mandated to offer CfDs and should be subject to ex-post monitoring.

It is also necessary that the market maker obligations relate to the appropriate forward CfD products that are required. For example, the majority of the peak products offered in the current SEM are through the DCs. Peak products are in high demand in the SEM, but they are rarely offered.

- ***Is there a requirement for arrangements to facilitate small party access? If so, what options should be considered?***

Yes there is a requirement for arrangements to facilitate small party access. The main items to consider are:

- Small clip sizes to facilitate small party access. In the current DC subscription rules, the minimum subscription is 0.1MW for a particular product and quarter. However at the OTC auctions, the minimum clip size is 5MW. Small clip sizes allow smaller players to participate in the forward market.
- The introduction of a clearing house or exchange to reduce the collateral requirements for forward trading.
- A variety of products on offer. There is no point in mandating market makers to sell CfDs if they only offer baseload products. A variety of CfDs should be on offer so that small suppliers can match their demand profiles.

4. Interactions with market power mitigation, including Directed Contracts

- ***What role should Directed Contracts play under I-SEM? What form should they take?***

It is suggested that market-maker obligations are placed on market participants above a defined market share. Directed contracts should only be used as a fall back mechanism.

Currently the DCs are conducted by ESB using fax. This is very different to the rest of the CfD market which is traded on the Tullett Prebon platform. It is suggested that all CfDs are offered on a centralised platform, where credit cover is posted centrally.

The interaction of the forward market with the CRM also needs to be considered as some generators may offer 2-way CfDs that are capped at the strike price of the reliability option.

- ***Are market power mitigation measures needed in the forward market? If so, what options are available and how could they be applied?***

Yes market power mitigation measures are needed in the forward market. As forward trading of power can only be done on a financial basis, it is essential that there is liquidity in the forward market for suppliers to lock in a fixed price for customers.

One of the key concerns is that in 2013, 85% of the publically traded CfDs in SEM were sold by ESB (SEM-14-073). This means that ESB has significant influence on the prices in the forward market.

It is suggested that market participants above a defined market share are required to submit CfD offers. There should be more than one market maker to ensure sufficient competition in the market. The RAs should monitor prices and volumes, and if sufficient volumes are not being contracted, further actions should be taken.

5. Mediums for trade and trading Institutions

- ***Is an I-SEM specific exchange or an I-SEM screen on an existing exchange preferable?***

One of the advantages of the current Tullett Prebon platform is that there are no joining fees and the brokerage fees are relatively low. The disadvantage of the current structure is that credit cover needs to be posted separately which each counterparty and for each contract type.

If the forward market is to be held on an exchange, the primary question is what are the joining fees, annual costs and charges per trade. If the costs are large, this may be a barrier to entry for smaller participants. This barrier does not currently exist for smaller participants as Tullett Prebon has no joining fees.

A cost benefit analysis needs to be conducted to determine whether the market size warrants an I-SEM specific exchange. If so, there should be netting between physical and forward positions. An I-SEM screen on an existing exchange may bring limitations and restrictions on product offerings, but joining fees, credit or transaction costs could be lower. These trade-offs need to be examined.

- ***What conditions are needed to support effective functioning of an I-SEM exchange?***

One of the key requirements for setting up an I-SEM exchange is to determine what level of credit cover to require from participants. However it first needs to be decided whether the volume and expected liquidity warrants the development of an I-SEM exchange.

- ***Should development of an exchange be left to the market or is specification from the RAs required?***

It is suggested that the exchange is specified by the RAs in consultation with industry stakeholders, to ensure the needs of all participants are addressed.

6. Factors affecting liquidity in the near-term markets

- ***Are there other issues which will affect liquidity in the near-term markets?***

The answers to the questions below, will have a major impact on the liquidity in each ex-ante market:

- Will larger players be mandated to trade a certain percentage of their power in the day ahead market?
- What reference price will REFIT be settled against?
- Will the intraday market consist of both continuous trading and auctions?

The intraday market will essentially be based on adjustment of positions due to generator outages and updated wind forecasts. It is at risk of being an extremely thin market especially if there is no incentive for wind to trade in this market and go straight to imbalance. There should be market makers in the intraday market and these should include utilities with large wind portfolios as well as thermal generation.

7. Design of the I-SEM Financial Transmission Rights

- ***What are the advantages and disadvantages of FTR Options or FTR Obligations? What is your preferred approach?***

| | FTR Option | FTR Obligation |
|----------------------|--|---|
| Advantages | <ul style="list-style-type: none"> • Allows supply companies to hedge power in the forward timeframe • Frees up the entire interconnector for cross border trade unlike PTRs | <ul style="list-style-type: none"> • Allows supply companies to hedge power in the forward timeframe • Frees up the entire interconnector for cross border trade unlike PTRs |
| Disadvantages | <ul style="list-style-type: none"> • If FTR Options are chosen over FTR Obligations, they will be traded at a premium as they carry less risk for market participants | <ul style="list-style-type: none"> • Currently not catered for in the draft Harmonised Allocation Rules (HAR) • Why should market participants be exposed to negative spreads if power didn't flow in that direction? |

Our preferred option is FTR Options as it limits market participants' exposure and is more intuitive.

- ***What measures need to be implemented to comply with financial regulations requirements?***

The following regulations will need to be considered when designing FTRs: EMIR, MIFID II and REMIT.

Under EMIR, financial trades need to be reported to a Trade Repository. The reporting requirements will depend on the status of the company. Likewise, under REMIT, the trades and orders will have to be reported to a Registered Reporting Mechanism.

In the design of I-SEM, it needs to be decided whether the operator will report this data on behalf of market participants, or whether it is up to market participants to report this data.

- ***How should transmission losses be factored into the FTR design?***

Transmission losses should be integrated into zonal pricing differentials. Therefore if there is a €10 price differential between the two markets and the transmission losses are 0.98, participants who have an FTR in the relevant direction should only receive €9.80.

Both interconnectors should be treated separately in terms of transmission losses. Otherwise Moyle will be subsidising the East-West Interconnector or future interconnectors.

8. Allocation

- ***What are the I-SEM specific issues that need to be considered in the development of the Single Allocation Platform?***

It is strongly suggested that FTR Options are chosen instead of FTR Obligations, otherwise the TSOs will have to develop appropriate harmonised Allocation Rules for Financial Transmission Right Obligations.

Specific I-SEM issues:

- FTRs
 - Start of trading day
 - Settlement of FTRs – On a daily basis?
 - How far out products will be offered and type of products
 - Will interconnector participants be able to participate in the CRM and how will this affect flows on the interconnectors?
 - Will the Single Allocation Platform report the trades under REMIT and EMIR on behalf of market participants?
- ***Should development of allocation arrangements be left to the market or is specification from the RAs required?***

Development of the allocation arrangements should be left to the market as the market has better knowledge than the RAs of the specific requirements and challenges.

9. Firmness

- ***What are the I-SEM specific issues that need to be considered in consideration of firmness?***

I-SEM specific issues

- Interconnector Availability
- Outages in the electricity network in Great Britain
- Outages in the electricity network in Ireland

Ultimately participant trading on the interconnector is financial. Therefore if the interconnector owners offer compensation for curtailment, this makes the interconnector capacity more valuable. If they do not, it decreases the value of the interconnector capacity. The Long Term Firmness Deadline also needs to be defined.

- ***Should treatment of firmness issues be left to the market or is input from the RAs required?***

Treatment of firmness should be left to the market, as the market knows the specific risks and challenges that will arise. They can also inform the interconnector owners of the premium they are willing to pay for firmness.

10. Revenue Adequacy

- ***What are the issues relating to revenue adequacy that need to be considered?***

One of key items that must be addressed relates to treatment of losses across the interconnectors. It is imperative that losses are dealt with separately across each interconnector or else Moyle will be subsidising the East-West interconnector and potentially future interconnectors.

The nature of how firmness and ramping are dealt with on the interconnectors will have an impact on the value of the capacity. The less risk the market participant is exposed to, the more they will pay for capacity.

Revenue adequacy is also linked to the allocation of FTRs. Depending on the feasibility that future congestion rents can be paid from the capacity revenues, then this will limit the number of FTRs allocated in either direction.

11. Market Power

- ***What potential market power issues are linked to FTRs? How can they be dealt with?***

CfDs and FTRs both offer supply companies a method to hedge their exposure to the future price of electricity in I-SEM. It is suggested that the volume of FTRs and CfDs traded by each participant is monitored. Potentially a situation could arise whereby a dominant seller of CfDs purchases all of the interconnector FTRs to inflate the CfD price.

Similarly a generator holding an FTR could withhold generation in the Day Ahead market to drive up the zonal I-SEM price and profit from the increased spread. Therefore both CfD and FTR trading should be subject to ex-post market monitoring.

12. 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?***

One of the key questions that needs to be answered is if market participants with FTRs can participate in the Capacity Remuneration Mechanism? If they can, how does this affect flows on the interconnector, if at all?

In relation to renewable certificates, currently LECs (Levy Exemption Certificates) are transferred with the physical flow of electricity. If a market participant has an FTR in the direction IE-GB and the electricity flows in that direction, the presumption is that the participant can transfer LECs with that capacity. Confirmation would be required from NIAUR, Ofgem and HMRC to assess whether this is the case. If so, the current arrangements for trading LECs would still stand. Otherwise, this would eliminate trading of LECs between Ireland and Great Britain.

13. Transitional Arrangements

- ***How should transition to FTRs be managed? What requirements are there for during the transition phase?***

Questions that need to be considered:

- Will all interconnector trading be conducted on the Auction Management Platform / Single Allocation Platform?
- When will the first auctions for Q4 2017 be held?
- How is credit cover managed? If FTR options are implemented, is collateral posted separately with each interconnector or centrally?
- Will collateral be required to cover 1 month of the position or longer?
- Will the AMP /Single Allocation Platform submit all of the data requirements under REMIT and EMIR?
- Do market participants de-register their interconnector units in SEM and BETTA?