



**Energia response to I-SEM Forwards and
Liquidity Detailed Design**

Forwards and Liquidity Discussion Paper SEM-15-010

27 March 2015

Executive Summary

This submission provides Energia's views on the scope and approach proposed to be taken in respect of the Forwards and Liquidity workstream outlined in Discussion Paper SEM-15-010. Our views are informed by extensive experience trading in the SEM spot and forward markets and trading GB power across the Moyle and EWIC interconnectors to service our customer needs and grow our customer base. We have made every effort to articulate our views clearly and comprehensively in this submission and have put forward considered responses to the questions consulted upon. We would welcome further constructive dialogue with the regulatory authorities (RAs) on these issues.

Market Power, Retail Competition and Forward Market Liquidity

Energia believes that progress can be made on forward market liquidity with the appropriate regulatory strategy. We believe effective management of market power in the forward timeframe must be a central tenant of this strategy, as evidenced by Baringa:

“Analysis of the current SEM forward market indicates exceptionally low levels of market led liquidity and exhibits dynamics that could be indicative of the exertion of market power.” (P.26)¹

Furthermore, we believe the RAs have the statutory mandate required to direct provision of forward market liquidity to promote retail competition.

Energia would stress that access to competitively priced, effective risk management instruments is of fundamental importance to the promotion of retail competition under the SEM and I-SEM. Experience from SEM indicates that underlying structural issues (market dominance), increasing levels of wind penetration, and a pool market design have undermined the development of a competitive forward market. These dynamics, explained further in section 2 of this response, are expected to persist and intensify under I-SEM and will further reinforce the position of dominance in the forward contracts market. Thus Energia is strongly of the view that a competitive forward market will not develop organically without regulatory direction and management.

Role of Directed Contracts

The exertion of market power in the SEM / I-SEM forward market could undermine the conditions necessary for effective retail competition and could result in inefficient retail customer pricing levels, regardless of spot market

¹ See Baringa Report (April 2014), ‘Promoting forward liquidity and mitigating market power in I-SEM’.

liquidity. However the current market power mitigation strategy for SEM is solely focused on spot market timeframes and gives no consideration to dominance levels in the forward contract market. We see this as a significant gap in the current SEM market power mitigation strategy that must be closed as soon as possible.

Energia therefore suggests that directed contract volumes be set at a level that is sufficient to manage market power in both forward and spot market timeframes, rather than with reference to the spot market only. We would welcome further discussion on how this could best be achieved. One option may be to determine concentration levels in relation to thermal market share only (a company's thermal share as a percentage of total thermal market share) under the assumption that thermal generation is required to hedge forward contract sales. Energia strongly recommends that the changes to the market power mitigation strategy outlined above are implemented as soon as possible in the SEM and not delayed until implementation of I-SEM.

Regulatory Reporting on Forward Contract Market

Effective, comprehensive regulatory reporting on SEM / I-SEM forward market trading dynamics is an essential element of the I-SEM market power mitigation strategy. Key metrics for regulatory reporting on forward market dynamics are identified in sections 2.3 and 2.4 of the Baringa report (April 2014) 'Promoting forward liquidity and mitigating market power in I-SEM'. It is Energia's view that increased transparency around forward market trading behaviours will help to incentivise and reinforce self-correcting behaviour.

Need for Continuity in Hedging Activities and Transitional Measures

It is vitally important that the RAs ensure there is continuity in hedging activities for suppliers in the transition from SEM to I-SEM. This includes the continuing sale of interconnector capacity and CfDs during the transitional period to ensure suppliers are not faced with a cliff edge in relation to hedging their exposures in the lead up to I-SEM. As transitional arrangements are likely to become an issue during the next 12 months we recommend that finding effective solutions to transitional issues should be prioritised within the workstream.

Standard Contract Terms and Netting of Collateral

Energia would strongly support standardisation of contractual terms and netting of collateral across I-SEM interconnectors and with other I-SEM markets where practical. As a general principle, simplifying contractual arrangements and reducing collateral requirements will help promote trade, generating liquidity, which in turn will support market access and therefore competition. We therefore request that this objective is considered as part of the development of the European single allocation platform and the set-up of an I-SEM exchange.

Exchange Based Trading

Energia strongly supports the development of exchange based trading in the I-SEM forward contract market. We believe exchange based trading will help promote liquidity by removing the barriers presented by the current bilateral trading arrangements. For example, implementation of exchange based trading would mean a central counterparty for all I-SEM forward contracts (the exchange) and standardisation of contractual and credit terms. It would also help facilitate efficient netting of collateral across I-SEM markets. It should therefore significantly improve market access and help promote increased participation by GB utilities.

Market Maker Obligations

There is merit in further consideration of market maker obligations but Energia has significant concern that imposition of market maker obligations in the forward timeframe will not be sufficient to manage forward market power under the I-SEM design for reasons explained in section 3.2 of this response. We would further emphasise that imposition of market maker obligations on dominant entities would in no way remove the requirement for ring fencing between ESB generation and supply businesses or the need for some form of direction by the RAs in relation to ESB forward contract volumes and pricing. We would further emphasise that the competition issues in GB and I-SEM are fundamentally different.

Role of I-SEM Interconnectors

The interconnectors in I-SEM are an extremely important component in addressing the liquidity issues faced by suppliers discussed above. It is therefore essential that the allocation platform supports any specific capacity products that are required by the I-SEM to provide direct access to effective hedging instruments by suppliers and to further promote liquidity in the forward contracts market. We therefore suggest that the RAs incorporate development of appropriate capacity product offerings into the scope of the Forwards and Liquidity workstream with a focus on supplier hedging.

Managing Market Power (I-SEM Interconnectors)

Given the role of interconnectors in I-SEM it is important there is effective mitigation of market power. Participants that are dominant in the I-SEM forward contract market could reinforce their dominance in the I-SEM forward contract market by bidding up the price of FTRs or by restricting the access of I-SEM Suppliers to FTRs. There is also the potential for I-SEM participants that also hold dominant positions in the GB market to exert market power in the I-SEM under market coupling arrangements. We believe both of these issues need careful consideration as part of the market power mitigation workstream and that the option of imposing volume limits on the FTR holdings of participants capable of exerting market power in I-SEM is considered as a

potential mitigation measure. Such an approach has been recommended by Baringa:

“The I-SEM consultation document highlights the potential for efficient market coupling to weaken the market power of dominant participants. In the forward market this dynamic is only effective in reducing market power to the extent that there is not a concentrated holding of Financial Transmission Rights (FTRs) or Physical Transmission Rights (PTRs) amongst dominant participants. Some form of maximum capacity holdings may therefore need to be considered to mitigate against this risk”. (page 15)²

Revenue Adequacy

Energia welcomes the fact that the issue of revenue adequacy under the I-SEM design has been raised in the Discussion Paper but we would strongly emphasise that the concept of revenue adequacy does not just apply to interconnector owners. In our responses to the HLD consultation, the HLD draft decision, RLG meetings 2.1 to 2.3 and the Building Blocks consultation we have highlighted areas that could undermine the principle of revenue adequacy under the I-SEM design, in particular for marginal generators. We would emphasise that ensuring revenue adequacy is fundamentally important in ensuring the long term sustainability of the market, maintaining robust security of supply and promoting conditions for competition in the generation sector.

² See Baringa Report (April 2014), ‘Promoting forward liquidity and mitigating market power in I-SEM’

1. Introduction

Energia is pleased to respond to the SEM Committee Discussion Paper (SEM-15-010) on the Forwards and Liquidity workstream for the I-SEM detailed design. We particularly welcome the initiative taken by the regulatory authorities (RAs), through this publication, to seek feedback on the scope and approach to be taken in respect of this workstream and would encourage a similar approach for future workstreams, including market power, capacity and DS3.

Having condensed our key points in the Executive Summary the remainder of this response addresses the substantive issues and questions raised in the Discussion Paper in more detail. Our views are informed by extensive experience trading in the SEM spot and forward markets and trading GB power across the Moyle and EWIC interconnectors to service our customer needs and grow our customer base. We have made every effort to articulate our views clearly and comprehensively and have put forward considered solutions to problems identified where possible, albeit it is difficult to be definitive on all issues at this stage.

We would welcome further constructive dialogue with the RAs on the points raised and firmly believe that progress can be made to protect and promote retail and wholesale competition with appropriate regulatory direction and management of market power and liquidity in the SEM and I-SEM.

Finally, as a general comment, Energia would note that long term stability in the regulatory environment is an essential component of promoting liquidity across I-SEM markets. Perceived regulatory risk in the SEM / I-SEM will undermine investment and discourage forward contracting by introducing uncertainty regarding the commercial risks associated with entering into longer term transactions. The 'minded to' decision on 'Outturn Availability' is a recent example of this kind and could, if implemented, act as a further barrier to forward market liquidity because of the implicit changes to the SEM firm access policy that results in increased commercial risks for generators when transacting forward. Under I-SEM this increase in commercial risk is likely to be translated into an increase in the offer prices submitted into capacity auctions. We would thus encourage the RAs to re-consider this 'minded to' decision in light of its wider negative consequences.

2. Lessons Learned from Forward Trading in SEM

The Discussion Paper states that the forwards and liquidity workstream will need to consider the lessons learned from SEM experience to date and evaluate the causes and their applicability in I-SEM in order to shape more effective forward trading under the new market. We welcome this exploration of lessons learned from SEM with a view to I-SEM and respond to the questions this raises below. We would further stress that urgent regulatory

steps are needed now to promote forward liquidity and thereby retail competition in the SEM.

Q1. Are there other issues which have affected forward liquidity in SEM or any comments on the applicability of the issues identified above [table in section 2.3 of SEM-15-010]?

Energia would emphasise that underlying structural issues, increased levels of wind penetration and a pool market design have undermined competitive pricing in the SEM forward market. The large fuel diverse portfolio of the dominant incumbent means that it maintains a large proportion of thermal market share in the SEM relative to other generation companies, regardless of increasing levels of wind. As thermal generation is required to hedge forward contract sales, the dominant incumbent is the only realistic source of domestic forward market liquidity in the SEM, resulting in it holding a significant position of dominance in the forward contracts market. Given the diversity and size of their portfolio, the dominant incumbent is significantly better placed to manage the scheduling risk associated with a pool market design compared to other smaller SEM generation companies and therefore the pool structure of the SEM, and the scheduling risk it creates for smaller generation companies, helps to further reinforce their position of dominance by effectively limiting the access of smaller generation companies to the SEM forward market. This undermines competitive pressures in the SEM forward market and leads to uncompetitive pricing and forward market dynamics that could be considered consistent with the exertion of market power, as evidenced by Baringa:

“Analysis of the current SEM forward market indicates exceptionally low levels of market led liquidity and exhibits dynamics that could be indicative of the exertion of market power.” (P.26)³

Q2. Which issues are expected to persist with introduction of I-SEM?

Moving into I-SEM it is difficult to see how the above dynamics will change. The dominant incumbent’s market share will decrease relatively more slowly than other generation companies in response to increasing levels of wind generation due to the size and diversity of its generation portfolio and the I-SEM market design effectively maintains a pool structure because of the ‘exclusivity’ of the energy trading arrangements. Moreover, as pointed out by the ESRI in their recent Working Paper No 497, the I-SEM trading arrangements are likely to result in an increase in the commercial risks faced by generators (scheduling risk) due to the modelling restrictions imposed on generators by EUPHEMIA order formats.

³ See Baringa Report (April 2014), ‘Promoting forward liquidity and mitigating market power in I-SEM’.

“The adoption of the new bidding algorithm [EUPHEMIA] will transfer some risks to the generators in terms of dispatching, as it could reject block orders that should be accepted by the market. Moreover, it is not clear how the technical constraints will be addressed by the new price algorithm. The risk bared by producers in the spot market may be transferred to consumers via the forward market risk premium” (p. 14)⁴.

The dominant incumbent is better placed to manage such risks due to the size and diversity of its generation portfolio and the information advantage this provides and therefore, increased trading risk under I-SEM can only further reinforce its dominance in the forward market timeframe.

Q.3 What are the priority issues to address under I-SEM and what possible solutions should be considered?

As Energia articulated in previous I-SEM responses during the high level design phase, physical forward contracting and self-scheduling would remove scheduling risk improving conditions for investment for merchant generation, thereby promoting competition in the forward contracts market. It would also introduce a de-facto price cap on forward market pricing; the cost of running alternative generation assets (e.g. ‘out of merit’ CCGTs in I-SEM). Note that currently pricing dynamics in the SEM forward market mean that a generator can be out of merit in the spot market but in merit in the forward market due to the premiums added to forward contract prices. This dynamic itself is indicative of inefficient transfer of spot market price expectations which, as evidenced by Baringa in their report ‘Promoting forward liquidity and mitigating market power in I-SEM’ (April 2014), may be indicative of the exertion of market power in forward timeframes.

In the absence of physical forward trading and self-scheduling and to avoid retail competition issues, in the face of market dominance and increasing levels of wind generation (which reduces overall thermal market share and increases the short positions of independent retail suppliers), careful consideration of the market power mitigation strategy for the I-SEM forward contract market is required. We make specific proposals on mitigation of market power and measures to promote forward market liquidity in our answers to later questions.

As set out comprehensively in our responses to the HLD consultation paper and the HLD proposed decision Energia maintains that allowing physical forward trading and self-scheduling under the I-SEM design would improve competitive dynamics in the I-SEM forward market. See sections 4.1.4 and

⁴ ESRI Working Paper No 497 (March 2015), ‘Competition and the Single Electricity Market: Which Lessons for Ireland’.

4.1.5 of our response to the HLD consultation SEM-14-008 and sections 3.2.8 and 5.2 of our response to the HLD proposed decision SEM-14-046.

In previous responses we have also suggested mechanisms that would promote spot market liquidity under such an approach and note that many of the same measures are required under the I-SEM design due to its non-mandatory nature. Cross reference sections 4.2.4.4, 4.2.4.7 and 4.2.5.4 of our response to the HLD consultation SEM-14-008 and section 5.3 of our response to the HLD proposed decision SEM-14-045.

3. Project Scope – Within Zone Forward Liquidity

The Discussion Paper identifies liquidity promoting measures for the Forward markets that the RAs currently consider should be assessed within the workstream. Further questions are highlighted upon which views from stakeholders are invited. We respond to the questions raised below under the various categories considered.

3.1 Specification/nature of forward products

The workstream will consider the specification and nature of financial forward products under I-SEM with the aim of creating arrangements and products that promote forward liquidity and meet the requirements of market participants.

Q4. What forward products are expected to be needed under I-SEM?

Taking the current suite of forward products in the SEM as a minimum starting point we suggest the following additional measures to better align contract offerings with the risk management requirements of suppliers and we suggest that these changes are implemented prior to I-SEM go-live:

1. A longer trading horizon for regulated directed contracts (c24 months) and for PSO backed contracts (c12 months). Extending the duration of the trading horizon will facilitate suppliers to implement hedging strategies and will also help in the development of a forward curve for the SEM / I-SEM.
2. More certainty regarding eligibility for regulated directed contracts across the suggested trading horizon. This would help facilitate planning of hedging strategies by suppliers.
3. More certainty regarding the availability of PSO backed contracts across the suggested trading horizon. Again, this would help facilitate planning of hedging strategies by suppliers.
4. Better balance in terms of offered contract duration – e.g. we suggest monthly products for periods up to 6 months ahead of delivery and quarterly products thereafter.
5. More alignment of SEM / I-SEM regulated directed contracts with GB forward traded products, in particular, less emphasis on mid merit 1

products and more emphasis on mid merit 2. This could help incentivise participation by GB players in the SEM / I-SEM forward market, particularly if exchange based trading was developed.

6. Given requirement for participants to be balance responsible under I-SEM there may be a need to develop intra-month forward hedging products to better facilitate position management. Energia would strongly emphasise, however, that this should not detract from the critical requirement of significantly improving liquidity in longer term hedging products across a 1 to 24 month trading horizon.

Q5. Should development of appropriate products be left to the market or is specification from the RAs required?

Given the structural issues in the SEM / I-SEM (e.g. the market dominance of the incumbent in spot and particularly forward market timeframes), we believe the regulatory authorities have a mandate and an obligation, consistent with their statutory duties, to promote retail competition by directing the provision of forward market liquidity. Directed contracts have an essential role to play in meeting this obligation by ensuring access by suppliers to hedging instruments to manage retail exposures. Directed contracts could also be used to help stimulate the conditions necessary to incentivise a more actively traded and liquid SEM / I-SEM forward market. It is therefore fundamentally important that the type and form of directed contracts is carefully considered. We have made some suggestions regarding how implementation of directed contracts could be further improved in our answer to later questions.

Energia would also emphasise that it is important that the regulatory authorities oversee and direct the form of legal contracts for the I-SEM financial forward market given the implementation of Reliability Options (ROs) as the I-SEM CRM. ROs are essentially another form of financial forward contracting and it is important that their implementation does not become a barrier to participation in the I-SEM forward energy market. We also have a concern that the bespoke nature of I-SEM financial forward contracts could act as an additional hurdle to GB participants engaging in the I-SEM forward market due to the requirement to work through the interaction between I-SEM CfDs and the RO scheme. Implementation of an I-SEM forward exchange may help mitigate this risk by facilitating a standard contract form for I-SEM CfD trading.

3.2 Nature of participation, including market participation obligations

The Discussion Paper states that there is scope to alter the nature of participation in I-SEM in order to support development of liquidity in the forward market, and in this context, discusses market maker and small party access options. Stakeholder views are then invited with reference to specific questions which Energia responds to below.

Q6. Is there a requirement for market maker arrangements?

There is merit in further consideration of market maker obligations but Energia has significant concern that imposition of market maker obligations on a dominant incumbent in the forward timeframe will not be sufficient to manage forward market power under the I-SEM design – see answer to question 7 below.

Energia would further emphasise that imposition of market maker obligations on a dominant participant in I-SEM would in no way remove the requirement for ring fencing between ESB generation and supply businesses (or the need for some form of direction by the RAs in relation to ESB forward contract volumes and pricing). The comparison with GB in paragraph 2.4.12 of the discussion paper is unfortunately unhelpful and has potential to misinform the debate in I-SEM. This is because it does not recognise the fundamental differences between the competition issues in GB and the competition issues in SEM / I-SEM. Competition issues in GB are focused on new supplier entry due to the presence of six large, vertically integrated companies, each with their own large generation portfolio. The issue in the SEM / I-SEM is the presence of a dominant incumbent made up of a ring-fenced, single, large, fuel diverse generation portfolio and ring-fenced, large supply business that, if vertically integrated, would undermine the fundamental conditions necessary to support retail competition. Given the dynamics of the SEM / I-SEM no other supply company could compete against such an entity.

Q7. If so, what options should be considered?

The efficacy of market maker obligations in managing forward market power (specifically forward contract pricing levels) in the I-SEM will depend upon the risk attributed by the market maker to someone accepting the bid that they would be mandated to post, at the regulated price spread, along with their offer. Energia has significant concern that a market maker in the I-SEM forward market will consider the risk of another participant accepting their bid price as minimal due to the potential scheduling risk associated with the I-SEM market arrangements. As the ESRI comment in their Working Paper No 497:

“The adoption of the new bidding algorithm [EUPHEMIA] will transfer some risks to the generators in terms of dispatching, as it could reject block orders that should be accepted by the market. Moreover, it is not clear how the technical constraints will be addressed by the new price algorithm. The risk bared by producers in the spot market may be transferred to consumers via the forward market risk premium” (p. 14)⁵.

⁵ ESRI Working Paper No 497 (March 2015), ‘Competition and the Single Electricity Market: Which Lessons for Ireland’.

Therefore in the absence of physical forward contracting and self-scheduling, which would effectively remove this risk, Energia strongly recommends that a robust form of regulation is required for all forward contract sales by a dominant incumbent in the interests of promoting retail competition to manage any potential exertion of market power in forward timeframes.

Q8. Is there a requirement for arrangements to facilitate small party access?

Energia strongly supports retail competition and the principle of equal market access for all participants, regardless of their size. We would emphasise however that the best way to ensure equal market access for all participants, and thereby promote retail competition, is to facilitate adequate provision of forward market contracts at competitive prices. As discussed in relation to market maker obligations it is important to appreciate that the competition issues in SEM / I-SEM are very different to the issues in the GB market given the presence of a dominant incumbent in the SEM / I-SEM generation and retail markets. Therefore the focus in SEM / I-SEM must be on maintaining the fundamental conditions required for retail competition, namely adequate provision of forward hedging instruments at competitive prices.

Q9. If so, what options should be considered?

In Energia's view the best way to promote market access is to mandate significant volumes of forward contract sales by the dominant incumbent generation business and remove barriers to trade. We therefore strongly support the continuation of directed contracts in I-SEM and the development of an I-SEM exchange / exchange screen. We discuss both these options in more detail in our answers to later questions.

3.3 Interactions with market power mitigation, including Directed Contracts

The Discussion Paper states that there is the potential that Directed Contracts might be applied to wider circumstances under I-SEM, and that the role for and potential application of Directed Contracts under I-SEM and as part of the financial forward trading arrangements needs specific consideration. Feedback to related questions is invited, to which Energia responds below.

Q10. What role should Directed Contracts play under I-SEM? What form should they take?

Directed Contracts should be used to manage market power in both spot and forward market timeframes. The current approach to market power mitigation sets directed contract levels only in relation to concentration levels in the spot market. This approach however does not address the potential for exertion of market power in the forward market timeframe. This is because concentration

levels in spot timeframes are not indicative of market power in forward timeframes, particularly in a market with high levels of wind penetration.

The exertion of market power in the forward market could undermine the conditions for effective retail competition and result in inefficient retail customer pricing levels, regardless of spot market liquidity levels. Energia therefore suggests that directed contract volumes be set at a level that is sufficient to manage market power in both the forward and spot market timeframes, rather than with reference to the spot market only. We would welcome further discussion on how this could best be achieved. One option may be to determine concentration levels in relation to thermal market share only (a company's thermal share as a percentage of total thermal market share) under the assumption that thermal generation is required to hedge forward contract sales.

Energia strongly recommends that the changes to the market power mitigation strategy outlined above are implemented as soon as possible in the SEM and not delayed until the implementation of I-SEM. The requirement to implement these changes as soon as possible is clearly evidenced by the conclusions reached by Baringa in their recent report quoted earlier⁶.

In terms of the form of directed contracts, Energia would welcome consideration of the following changes that would help further align directed contract product offerings with the risk management requirements of suppliers. We suggest that these changes are implemented prior to I-SEM go-live.

1. Volumes sold up to 27 months in advance – e.g. a 3 month lead time with a trading horizon spanning 24 months. Extending the duration of the trading horizon will facilitate suppliers to implement hedging strategies and will also help in the development of a forward curve for the SEM / I-SEM.
2. Fixed eligibility for the 24 month trading window to provide certainty to suppliers of their directed contract eligibility. This will provide support to retail competition by providing more certainty in relation to available hedging products and thereby facilitate planning of retail hedging strategies by suppliers.
3. Similar cumulative ladder approach to volumes offered in each directed contract round but with monthly products being offered for the first 6 months of the trading horizon with quarterly products sold for the period thereafter. This would allow suppliers to better manage month to month changes in consumption.
4. Provision of mid merit 2 products and less emphasis on mid merit 1 product. Increasing product alignment with GB contract types could

⁶ Ibid footnote 1.

help incentivise GB players to participate in the SEM / I-SEM forward market, particularly if exchange based trading were developed.

5. Careful monitoring and reporting on trade dynamics by the RAs; in particular, close scrutiny of the trading behaviours of the generation and supply businesses of dominant participants.

Energia would strongly emphasise that PSO backed CfD contracts also provide essential access to hedging instruments for suppliers and we therefore recommend that they are maintained in the I-SEM. To better align PSO contract offerings with the risk management requirements of suppliers we have suggested the following changes to their current format. Again, we suggest that these changes are implemented prior to I-SEM go-live.

1. Contracts are sold up to 15 months in advance – e.g. a 3 month lead time with a trading window spanning 12 months. Extending the duration of the trading horizon will facilitate suppliers to implement hedging strategies and will also help in the development of a forward curve for the SEM / I-SEM.
2. Contract volumes fixed for the 12 month trading window to provide certainty to suppliers of contract availability. This will provide support to retail competition by providing more certainty in relation to available hedging products and thereby facilitate planning of retail hedging strategies.
3. Similar cumulative ladder approach as directed contracts process in each PSO contract round but with monthly products being offered for the first 6 months of the trading horizon with quarterly products sold for the period thereafter. This would allow suppliers to better manage month to month changes in consumption.
4. Increasing product alignment with GB contract types could help incentivise GB players to participate in the SEM / I-SEM forward market, particularly if exchange based trading were developed.
6. Careful monitoring and reporting on trade dynamics by the RAs; in particular, close scrutiny of the trading behaviours of the supply business of the dominant incumbent.

Energia would welcome further consideration and debate around possible approaches to the sale of directed contracts and PSO backed contracts that could help promote wider liquidity in the I-SEM forward market. One such option may be to sell such contracts through an exchange or trading screen in designated liquidity windows. For such an approach to work the RAs would need to set a price cap but the approach would allow the market to establish the trade price. In the case of directed contracts a volume cap (based on participant eligibility) would need to be imposed on participants. Further discussion on the specifics of how this could work would be required but the approach could encourage liquidity pooling and may help promote more

competitive dynamics on the bid side of the market, while providing robust regulation of the offer side (where there is a lack of competition due to structural issues).

Energia would strongly emphasise, however, that regardless of the approach taken to the sale of directed and PSO backed contracts, effective, comprehensive regulatory monitoring and reporting on SEM / I-SEM forward market trading dynamics is required to re-enforce self-correcting behaviour and help ensure that the conditions necessary to maintain retail competition are maintained in the SEM / I-SEM forward market.

Given the increasing level of wind penetration in SEM / I-SEM and the shrinking market share of thermal generation, Energia would welcome further regulatory led debate in relation to options that could allow wind generation to offer forward contracts. This could potentially be achieved by socialising the commercial risks associated with forward contract sales by intermittent generation. Energia therefore believe it would be worthwhile setting up a formal working group to consider possible approaches to implementing PSO backed forward contract sales by wind assets, such as those participating under the Aggregator of Last Resort Scheme.

Q11. Are market power mitigation measures needed in the forward market?

Energia notes that the current market power mitigation strategy for SEM is solely focused on spot market timeframes and gives no consideration to the dominance levels in the forward contract market. We see this as a significant gap in the current SEM market power mitigation strategy that, in light of the conclusions reached by Baringa in their report quoted earlier, must be closed as soon as possible.

The forward contract market is fundamental to suppliers being able to effectively manage their commercial risks and efficiently pass through spot market pricing levels to end consumers. A dysfunctional forward market in SEM / I-SEM will therefore result in retail competition issues and inefficient retail pricing, regardless of the liquidity levels in spot market timeframes. As the ESRI note in their Working Paper No 497:

“The current design of the Irish electricity market (SEM)...efficiently regulates the presence of market power in the spot market. Unfortunately, the lack of liquid and transparent forward markets may inhibit the transfer of competitive prices to the final consumers...” (p.12)

Given that these fundamental issues apply equally in the current SEM, Energia therefore advise that the changes we have suggested to the market power mitigation framework should be implemented as soon as possible and not delayed until the start of I-SEM.

Q12. If so, what options are available and how could they be applied?

Exertion of market power in the forward timeframe could take the form of either inflated pricing (relative to competitive levels) or decreased liquidity (a dominant player physically or financially withholding volume). The most obvious solution to these risks is to impose a high volume of directed contracts onto participants with dominant forward market positions – see answer to question 10 above. However we would emphasise that effective, comprehensive regulatory reporting on SEM / I-SEM forward market trading dynamics is also an essential element of the I-SEM market power mitigation strategy. Key metrics for regulatory reporting on forward market dynamics are identified in sections 2.3 and 2.4 of the Baringa report (April 2014) ‘Promoting forward liquidity and mitigating market power in I-SEM’. Energia believe that increased transparency around forward market trading behaviours will help to incentivise and reinforce self-correcting behaviour.

3.4 Mediums for trade and trading institutions

The Discussion Paper correctly identifies significant problems experienced with bilateral or over-the-counter (OTC) trading of forward contracts in the all-island market and states that an exchange can have a number of advantages by reducing trading costs, increasing competition, producing a publicly observable price and allowing credit arrangements to be centralised, all of which should encourage greater liquidity and increase the opportunity for smaller and new entrants to the market.

We respond below to the questions raised under this topic.

Q13. Is an I-SEM specific exchange or an I-SEM screen on an existing exchange preferable?

Energia strongly supports the development of exchange based trading in the I-SEM forward contract market. We believe exchange based trading will help promote liquidity by removing the barriers presented by the current bilateral trading arrangements. For example, implementation of exchange based trading would mean a central counterparty for all I-SEM forward contracts (the exchange) and standardisation of contractual and credit terms. It would also help facilitate efficient netting of collateral across I-SEM markets. It should therefore significantly improve market access and help promote increased participation by GB utilities.

Exchange based trading could also help mitigate market power if implemented as part of a wider suite of measure. For example, setting up an I-SEM specific exchange may help to facilitate more effective regulatory monitoring and reporting around the forward market, as it could be specifically

designed to support such regulatory activities.⁷ A form of screen based trading via an exchange could also help improve transparency around forward market price formation, which we view as an important element of managing market power as explained further below.

From extensive experience of operating under the SEM forward market arrangements Energia would emphasise that auction formats can reinforce market power. For example, the auction formats that have been used to sell forward contracts in the SEM to date allow the seller to set the minimum value of contracts by means of a reserve price (determine price expectations), while, at the same time, restricting the buyer from viewing the bid prices of other participants. In a market where there is low liquidity this dynamic helps to reinforce the market power of a seller because the buyer will tend to submit bids that are higher than they actually need to in order to mitigate the risk associated with not securing volume. This creates an inflationary pressure on prices. Adoption of exchange based auctions may help address these issues and we would welcome further consideration of these, particularly if our concerns regarding the lack of market wide transparency around bid prices and the ability of sellers to set reserve prices could be addressed.

Energia believes that setting up an I-SEM specific exchange is preferable to an I-SEM screen on an existing exchange as it would help to facilitate credit netting arrangements across I-SEM markets and potentially provide the RAs with more scope in terms of monitoring and reporting on forward market dynamics. However, we remain cognisant of the small size of the market and therefore suggest that the RAs carry out more detailed analysis in this area. One option for funding the development and ongoing operation of an I-SEM specific exchange is through a public service obligation. This may be justifiable on the grounds of the benefits such an exchange would provide in promoting forward market liquidity and therefore retail competition. Regardless of the approach taken by the RAs to implementing an exchange Energia would strongly recommend that the adopted approach facilitates:

1. Significant improvements in market access;
2. A form of trading that does not further reinforce market power in forward timeframes;
3. Increased transparency around price formation;
4. Detailed regulatory monitoring and reporting on trading dynamics; and
5. To the full extent possible, netting of collateral across I-SEM markets.

Q14. What conditions are needed to support effective functioning of an I-SEM exchange?

⁷ As previously discussed, we view the lack of transparency and formal reporting around forward market trading dynamics as a significant gap in the current market power mitigation framework that needs addressed as soon as possible.

Given the small size of the I-SEM market it is important that everything possible is done to maximise the volume of contracts traded through the exchange / exchange screen. This includes:

1. Straightforward, reasonable contract terms
2. Straightforward, reasonable credit terms
3. Minimising general cost of transacting
4. Flexibility in the form of collateral – e.g. LoC
5. Trading of directed / PSO backed contracts through the exchange / exchange screen
6. Designated trading windows to pool liquidity – similar to the current OTC trading sessions but more frequent
7. Ensuring that other elements of the I-SEM design does not undermine incentives to contract forward. For example:
 - a. Scheduling risk caused by proposed use of EUPHEMIA.
 - b. Reliability options (which are effectively a form of forward contracting). These need to be appropriately designed so as not to interfere with I-SEM forward contract market.

Q15. Should development of an exchange be left to the market or is specification from the RAs required?

Energia believes that it is essential that development of an I-SEM exchange is centrally managed by the RAs. Experience from SEM indicates that a competitive forward market will not develop organically in I-SEM without direct regulatory intervention because of the underlying structural issues in the market (notably market dominance). We note that liquidity on the current OTC screen remains poor with uncompetitive pricing on product offerings.

Given the small size of the market, it is also difficult to see how an exchange / exchange screen could develop for the I-SEM without the backing of the regulator. For example, the RAs may be able to guarantee exclusive trading rights for forward contracts, including directed contract trade volumes or provide some form of financial support (e.g. through a public service obligation).

4. Project Scope – Within Zone Spot Market Liquidity

Under this heading the Discussion Paper identifies relevant characteristics of the spot markets that will affect liquidity, covering the following areas:

- Energy imbalance arrangements
- Gate Closure
- Product availability
- Demand side participation
- Variable generation participation
- Aggregation
- Non-physical participation

- Transparency and reporting
- Platform for intraday trading
- Interaction with RES support
- Interaction with Reliability Options

View are invited on the following question to which we response below along with some initial comments regarding the areas identified above.

Q16. Are there other issues which will affect liquidity in the near-term markets?

Liquidity in near term markets will be affected by the following additional factors.

TSO Approach to Dispatch

The approach taken by the TSO to dispatching the system under the I-SEM trading arrangements will have a significant effect on liquidity in ex-ante markets. In particular, extensive early action by the TSO (i.e. prior to intra-day market gate closure) could undermine liquidity in the intra-day market by displacing market trades or changing incentives on generators. It could also distort price formation in the balancing market affecting the efficacy of market price signals. We have discussed these issues at length in our recent responses to RLG meetings 2.1 to 2.3, the Eirgrid I-SEM modelling proposal (a copy of which has been submitted along with this response) and our Building Blocks consultation response.

We would again take this opportunity to strongly advise that the approach taken by the TSO to dispatch under the I-SEM design requires very careful consideration and should be properly addressed prior to proceeding with the detailed design of the energy markets, particularly the balancing market. The same point applies in relation to any decision regarding the implementation of policy decisions relating to the management of the transmission system or the physical dispatch of generation assets, including interconnectors. Adopting such an approach will ensure that mechanisms provided to the TSO within the energy market rules are consistent with the overarching philosophy of the I-SEM design and that the TSO's approach to dispatch / transmission system management will deliver upon the intent of SEM Committee decisions on policy areas such as firm access.

Detailed Design of the Balancing Market

Energia would emphasise the need for rigorous qualitative and, where appropriate, quantitative modelling of key design proposals for the balancing market. Such modelling should be based upon the TSO's proposed approach to dispatch / transmission system management under the I-SEM high level design and should be focused on determining the potential effects of design proposals on balancing market trade dynamics and price formation. As explained in our response to EirGrid in relation to their I-SEM modelling

proposal, their current proposed approach to modelling dispatch dynamics in I-SEM is not appropriate and, given the nature of the assumptions made, could actually be misleading.

As the balancing market creates the price signals that incentivise participation in earlier energy market timeframes, appropriate design of the balancing market will have a fundamental effect on liquidity levels in near term markets. It is therefore fundamentally important that the implications of implementing design proposals relating to key areas of the balancing market in the context of I-SEM are well understood and properly debated and consulted upon prior to the SEM Committee taking any decisions on them to ensure the balancing market functions as intended.

Energia would stress that to proceed with the detailed design of the balancing market, which in scale is equivalent to the design of the current SEM ex-post pool (although we note the implications of the TSO approach to dispatch for SEM was considerably less given the implementation of a constraint payment mechanism), without carrying out appropriate qualitative or quantitative modelling would mean that consultations are proceeding without informed debate and decisions are being taken without sufficient evidence to support conclusions regarding their potential implications for market incentives, liquidity or ultimately I-SEM consumers.

Effective Mitigation of Market Power

Energia has significant concerns regarding the potential effect of information asymmetry on liquidity in the intra-day market; the ability of a large portfolio player to net off imbalances across their generation portfolio, weakening their incentives to trade in intra-day timeframes. The incentives on ring-fenced, dominant generation and supply businesses to trade in the intra-day market are further weakened by their ability, at a corporate level, to net off imbalance exposures between their generation and supply businesses. Therefore, to promote liquidity in intra-day timeframes, Energia suggests that the participation of ring-fenced, dominant generation and supply businesses in the intra-day market is subject to some form of regulation.

Liquidity in intra-day timeframes is essential to facilitate management of participant balance exposures and lack of liquidity could undermine the principle of revenue adequacy due to the potential requirement for generators to trade through the intra-day markets to achieve a technically feasible contract positions if there are issue implementing technical constraints through EUPHEMIA order formats. The principle of revenue adequacy is discussed in more detail in our answer to question 24 below.

Robust Intra-Day Market Fall Back Procedure

Given the importance of the intra-day market to managing imbalance exposures Energia would emphasise the need to have a robust fall-back

procedure for the intra-day market should problems arise with XBID. The procedure should facilitate intra-day trading amongst I-SEM participants.

Interaction with other Instruments

Energia would welcome clarity regarding the process and timings around decisions on RES support mechanisms under the I-SEM project plan.

In our recent response to RLG meetings 2.1 to 2.3 we highlighted the risks of the detailed design process proceeding on the basis of implicit assumptions regarding future design decisions / important policy areas. RES support mechanisms and the reference price for reliability options are examples of these. We suggested that any major assumptions influencing the choice of design proposals presented in RLG meetings or formal consultations should be made explicit so that any decisions taken on the basis of such assumptions could be re-evaluated if those assumptions later prove to be false. We argued that adopting such an approach to the I-SEM design process would help to mitigate the risk of unintended consequences for participants and consumers.

5. Project Scope – Cross Border Financial Instruments

In the discussion of cross border financial instruments, the Discussion Paper reflects on the HLD decision in favour of FTRs and notes the following objectives that FTR arrangements should meet, which it is stated are consistent with the overall objectives for I-SEM:

- promote efficient use of cross-zonal transmission;
- promote competition within I-SEM and between zones;
- be compatible with market power mitigation measures; and
- provide adequate return for existing assets and appropriate signals for future cross-border investment.

With the above in mind, the Discussion Paper states that work under this workstream to develop FTRs for I-SEM must take into account the following, consistent with the FCA Network Code:

- Design of I-SEM FTRs
- Allocation
- Firmness
- Revenue Adequacy
- Market Power
- Interaction With CfDs, Reliability Options And Renewable Certificates
- Transitional Arrangements

Views are invited in response to various questions raised.

Energia's feedback is below.

Q17. What are the advantages and disadvantages of FTR Options or FTR Obligations? What is your preferred approach?

Energia would welcome clarity on the scope of discretion required for implementation of FTRs in I-SEM as we would have significant concerns if I-SEM was moving in a different direction than the rest of Europe on this issue. We would also welcome more information regarding when agreement will be reached with Ofgem on the implementation of FTRs for I-SEM interconnectors. We would stress that if FTRs cannot be successfully implemented in I-SEM that this would create significant problems for the high-level design due to the inequality it creates in market access between interconnector users (who could essentially self-schedule under PTRs) and other I-SEM generators (who could not).

In relation to FTR Options our initial view is that they would seem to more closely resemble the current implementation of PTRs in the SEM, where participants have the option (through the price they submit to the SEM pool) not to flow power if the price spread is in the opposite direction to that required in relation to their capacity holding – e.g. if the price in GB is higher than in SEM then under the current PTR set up a participant with import capacity can avoid flowing power into I-SEM and sell back in GB and therefore their exposure to the negative price spread is zero as it would be under an FTR option. FTR obligations would seem more akin to a must flow PTR where the option not to flow is removed and therefore the participant is exposed to the negative price spread.

In theory the additional risk for participants under an FTR obligation should be reflected in the price paid for the product. We have concerns however that exertion of market power in the I-SEM forward market could inflate forward contract prices resulting in an under-pricing of the risk associated with FTR obligation by suppliers due to the cost of hedging through CfDs. This dynamic would result in further increased commercial risk on suppliers exacerbating market power concerns and further undermining retail competition. It could also discourage entry into the I-SEM forward contract market by GB participants who may not be willing to pay the same premium as I-SEM suppliers and therefore FTR obligations could act as a further barrier to liquidity in the I-SEM forward contract market.

Despite our reservations, at this early stage in the process, we nevertheless believe it is worth consulting on both FTR options and FTR obligations but we note from review of Annex 1 of the ENTSOE Draft Allocation Rules for Forward Capacity Allocation dated 2 March 2015 that seemingly no other interconnectors in Europe have implemented FTR obligations to date.

Q18. What measures need to be implemented to comply with financial regulation requirements?

Energia would caution against any unnecessary measures that further increase the operational burden on participants. The I-SEM design is extremely complex in relation to the small size of the market and the operational burden on participants is already excessive. As a general principle Energia believes that central solutions to reporting requirements under European regulations such as (MIFID II, EMIR, REMIT etc.) should be implemented wherever possible. Such an approach would reduce operational, legal and administrative overheads on existing participants and help prevent them becoming a barrier to new entry to the I-SEM, particularly for smaller participants.

Q19. How should transmission losses be factored into FTR design?

Given the cash flow under an FTR will be determined with reference to the price differential between GB and I-SEM as determined through day-ahead market coupling in theory, the design of FTRs should reflect the potential cash out mechanics of the FTR holder and the interconnector owner in each respective market (unless such an approach undermined the usefulness of the FTR as a hedging tool for suppliers further exacerbating forward market liquidity issues). This is to ensure that there is not a mismatch between the FTR and the physical transaction it is representing, which could open up an exposure under the instrument. It is difficult however to comment definitively on the issue at the present time, given the lack of information provided in the paper.

The problem may be linked to the modelling of physical losses on the IC which would create a price dead band. If the price differential was within this dead band no power would flow on the interconnector under coupling. Under such a scenario the price differential would still generate a payment under the FTR without an accompanying physical flow. This would mean that the IC owner was exposed under the FTR because under this scenario they would not receive payment on a physical flow to cash out the FTR.

Energia would emphasise however that costs incurred on I-SEM interconnectors are socialised and therefore some exposure for IC owners could potentially be justified (subject to a cost benefit analysis) to support increased access to effective hedging products for I-SEM retail suppliers. Increased access to hedging instruments would promote retail competition and therefore lower costs for I-SEM consumers over the longer term.

To facilitate proper debate and consideration on the treatment of losses under FTR design we suggest that the issue is consulted upon in more detail. However, Energia would stress that in light of the potential issues in the I-SEM forward contract market (i.e. market power and liquidity) the primary objective of FTR design should be to deliver robust hedging instruments for I-SEM suppliers.

Q20. What are the I-SEM specific issues that need to be considered in development of single allocation Platform?

The interconnectors in I-SEM are an extremely important component in addressing the liquidity issues faced by suppliers. It is therefore essential that the allocation platform supports any specific capacity products that are required by the I-SEM to provide direct access to effective hedging instruments by suppliers and to further promote liquidity in the forward contracts market. There is a potential risk that the design process for the platform will require compromise because of the allocation platform's centralised role across European markets. This risk will increase to the extent the approach to interconnector trading in I-SEM is not closely synchronised with the direction of travel in the rest of Europe.

In terms of the specific capacity products required in I-SEM, Energia would welcome further consultation in this area. As previously stated, we view the interconnectors in I-SEM as an important component in addressing the liquidity issues faced by suppliers, and we therefore suggest that the RAs incorporate development of appropriate capacity product offerings into the scope of the Forwards and Liquidities workstream. Furthermore, we would welcome the RAs careful consideration of how the utility of the interconnectors can be maximised to address liquidity issues in I-SEM by development of capacity product offerings. To facilitate further discussion in this area we have provided some suggested changes to capacity product offerings below. These changes could be implemented in the current SEM.

1. An increase in the volume of longer term import capacity products offered on SEM / I-SEM interconnectors – e.g. quarterly, seasonal and annual products – with longer lead times of up to 6 months ahead of delivery. This would better facilitate planning of hedging strategies by I-SEM suppliers and again could help promote participation in the I-SEM forward market by GB participants.
2. Auctioning of monthly import capacity over a six month trading horizon facilitating a lead time to delivery – e.g. during each month M auctioning monthly capacity products for delivery months M+1 to M+6. This would better facilitate management of month to month changes in consumption by I-SEM suppliers and again could help promote participation in the I-SEM forward market by GB participants.

Energia would strongly support standardisation of contractual terms and netting of collateral across I-SEM interconnectors and with other I-SEM markets where practical. As a general principle, simplifying contractual arrangements and reducing collateral requirements will help promote trade, generating liquidity, which in turn will support market access and therefore

competition. We therefore request that this objective is considered as part of the development of the European single allocation platform.

Energia would also welcome more clarity on how the RAs are able to ensure that I-SEM specific issues are addressed in the design of the single centralised allocation platform – i.e. an explanation of the governance arrangements around the design process and the ongoing management of the platform. As already stated in our response to question 17 above, no other market in Europe seems to utilise FTR obligations, while the majority of markets use PTRs. We therefore have some concern that the I-SEM could potentially be travelling in a different direction to other European markets. As previously discussed above, if this were the case it is then likely to lead to ongoing issues in relation to negotiation and compliance with network codes, increasing the risk to I-SEM liquidity in relation to the future development and management of the European single allocation platform.

Q21 Should development of allocation arrangements be left to the market or is specification from the RAs required?

Given that allocation of capacity on I-SEM interconnectors is governed by the FCA Network Code the RAs need to ensure that the arrangements implemented in I-SEM are compliant with European requirements. Furthermore, it seems that the RAs may need to influence the FCA Network Code, as well as the design of the Single Allocation Platform, to ensure they accommodate I-SEM specific requirements. Therefore it would seem necessary for the RAs to centrally facilitate development of the capacity allocation arrangements for I-SEM interconnectors to facilitate their negotiations in relation to the FCA network code and design of the Single Allocation Platform and to ensure that the arrangements implemented for the I-SEM are fit for purpose and unlikely to cause further compliance issues in future.

Q22 What are the I-SEM specific issues that need to be considered in relation to firmness?

Energia would strongly emphasise that, in light of the challenges faced by suppliers in the I-SEM forward contract markets (i.e. market power and liquidity), and in the interests of promoting retail competition, that the provision of capacity products on I-SEM interconnectors is focused primarily upon provision of effective hedging instruments for I-SEM suppliers. We therefore request that the treatment of firmness is carefully considered from this perspective.

We agree with ACER's assessment that weakening the obligations regarding the firmness of interconnector capacity products would undermine incentives on interconnector owners to properly maintain their assets. Undermining these incentives is likely to result in increased forced outage rates on I-SEM

interconnectors and therefore increased market inefficiencies over the longer term. Furthermore, transferring the financial risks of interconnector outages onto interconnector users (i.e. suppliers) will further undermine retail competition in I-SEM by placing an additional financial burden on suppliers, a financial burden that is likely to increase over time due to the weakening of incentives on interconnector owners.

The risk of forced outages on interconnectors is presumably difficult to estimate, even for interconnector operators. The financial risk of forced outages to interconnector users however is extremely difficult to estimate. Interconnector users have no access to technical information regarding the maintenance status of interconnectors and no experience of the technical risks associated with operating interconnectors and therefore it is extremely unlikely that the financial risk of interconnector forced outages will be accurately reflected in the bids submitted for capacity products. This is particularly the case in a market such as the I-SEM where the costs of alternative hedging options for suppliers could be inflated above fair value due to market power issues and low liquidity levels. Inefficient pricing of this risk (which in the context of the dynamics in I-SEM we believe is likely to be its underestimation) is what increases the financial burden on suppliers.

On the other hand, promoting robust obligations regarding the firmness of interconnector capacity products may, on occasions, increase short term costs for consumers (e.g. during a forced outage) but in so doing will reduce consumer costs over the longer term by providing the correct incentives for interconnector owners to maintain the availability of interconnectors and therefore market efficiency, and by significantly reducing the perception of financial risk for interconnector users (i.e. suppliers), thereby promoting retail competition.

Q23. Should treatment of firmness issues be left to the market or is input from the RAs required?

Given the need to comply with European requirements on ‘firmness’ and for the RAs to constructively engage in the European debate on the treatment of firmness on behalf of I-SEM consumers, it would seem necessary for the RAs to centrally facilitate development of the firmness policy for interconnector capacity products in the I-SEM. This will help ensure that the arrangements implemented for the I-SEM are fit for purpose and unlikely to cause further compliance issues in future.

Q24. What are the issues relating to revenue adequacy that need to be considered?

Energia welcomes the fact that the issue of revenue adequacy under the I-SEM design has been raised in this paper but we would strongly emphasise that the concept of revenue adequacy does not just apply to interconnector owners. In fact, in the context of I-SEM, given the socialisation of costs

associated with the operation of interconnectors, one could argue that the issue of revenue adequacy is less of a concern for interconnector owners than for other participants.

Energia, however, is acutely aware of the need to minimise cost for consumers and therefore would support the general principle that the I-SEM market rules should promote revenue adequacy by adequately reflecting, through commercial arrangements, the realities of operating physical assets. This principle, however, should be applied equally to generators and to interconnectors. Energia would further stress that in light of the potential issues in the I-SEM forward contract market (i.e. market power and liquidity) the primary objective of FTRs should be to deliver robust hedging instruments for I-SEM suppliers. This objective is consistent with the objectives of interconnector owners and regulators as it is only through the sale of FTRs that a longer term, secure revenue stream for interconnector assets can be generated thereby ensuring a more stable return on existing assets and providing the conditions necessary to secure financing for new investment. Therefore, to the extent that selling FTRs forward under the I-SEM design could lead to revenue adequacy issues, it would seem indicative of more fundamental problems with the market design that would need further careful consideration and review.

In our responses to the HLD consultation, the HLD draft decision, RLG meetings 2.1 to 2.3 and the Building Blocks consultation we have highlighted areas that could undermine the principle of revenue adequacy under the I-SEM design, in particular for marginal generators. We will not repeat them in this response but would emphasise that ensuring revenue adequacy is fundamentally important in ensuring the long term sustainability of the market, maintaining robust security of supply and promoting conditions for competition in the generation sector. Energia would also stress that access to competitively priced, effective risk management instruments is of fundamental importance to the promotion of retail competition under the SEM and I-SEM.

Q25. What potential market power issues are linked to FTRs? How can they be dealt with?

Energia recommends that the RAs closely monitor the bidding behaviours of participants that are dominant in the I-SEM forward contract market. The RAs should also monitor the volume of their FTR holdings. Such participants could reinforce their dominance in the I-SEM forward contract market by bidding up the price of FTRs or by restricting the access of I-SEM Suppliers to FTRs.

Energia would also emphasise that the regulatory authorities need to be cognisant of the potential for I-SEM participants that also hold dominant positions in the GB market to exert market power in the I-SEM under market coupling arrangements. The potential to exert market power in I-SEM could actually be exacerbated by prescriptive bidding rules in I-SEM that would

indicate to such participants how generators in I-SEM were likely to offer into the day-ahead and intra-day markets.

We believe both of these issues need careful consideration as part of the market power mitigation workstream and that the option of imposing volume limits on the FTR holdings of participants capable of exerting market power in I-SEM is considered as a potential mitigation measure. Such an approach has been recommended by Baringa:

“The I-SEM consultation document highlights the potential for efficient market coupling to weaken the market power of dominant participants. In the forward market this dynamic is only effective in reducing market power to the extent that there is not a concentrated holding of Financial Transmission Rights (FTRs) or Physical Transmission Rights (PTRs) amongst dominant participants. Some form of maximum capacity holdings may therefore need to be considered to mitigate against this risk”. (page 15)⁸

Q26. 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?

The I-SEM design requires implementation of a number of different financial forward contracting instruments – e.g. CfDs, FTRs and ROs. It is essential that these instruments are carefully designed to ensure that they work together as a coherent suite of arrangements. For example, it is essential that the design of reliability options does not preclude the sale of CfDs by I-SEM generators. Furthermore, that the contractual terms put in place for FTRs do not create exposures on holders that undermine their hedge effectiveness for suppliers or could act as a potential barrier to participation in the I-SEM forward market by non-I-SEM participants – e.g. a lack of financial firmness.

Energia would also again emphasise the importance of minimising collateral requirements under these various financial instruments and would welcome further discussion and debate on potential options that could be implemented to achieve this.

Q27. How should transition to FTRs be managed? What requirements are there during the transition phase?

Energia would strongly emphasise that it is important that I-SEM suppliers are not faced with a cliff edge in relation to hedging their exposures in the lead up to I-SEM. It is incumbent upon the RAs to ensure that there is continuity in hedging activities in the transition from SEM to I-SEM. This includes the continuing sale of interconnector capacity and CfDs during the transitional period leading into I-SEM.

⁸ See Baringa Report (April 2014), ‘Promoting forward liquidity and mitigating market power in I-SEM’

To support the continuing sale of interconnector capacity, clarity on FTR design is required to facilitate assessment of risk under the instrument and therefore their proper valuation. Mechanisms need to be agreed to facilitate translation of pre-existing PTR arrangements into FTR arrangements at I-SEM go-live and such arrangements need to accommodate potential delays to the start of I-SEM. Therefore, choosing a form of FTRs that more closely aligns with current SEM PTRs (i.e. FTR Options) may more easily facilitate the implementation of these mechanisms.

To support the continuing sale of CfDs during the transitional period Energia suggests a significant increase in directed contract volumes. As stated in our answers to previous questions we believe such an increase is required to mitigate market power concerns in the SEM / I-SEM forward market but significantly increasing DC volumes prior to I-SEM go live would also have the additional benefit of ensuring access to hedging products for suppliers during the transitioning period to I-SEM. On similar grounds we would strongly recommend the continued sale of PSO backed forward contract sales during the transitional period leading up to I-SEM go-live and beyond. PSO backed contracts are an important source of liquidity for I-SEM suppliers. Adopting some of the changes we have proposed to DC and PSO formats prior to I-SEM go-live would also help to improve the range of hedging options available for suppliers during the transitional period to counteract any potential reductions in NDC volumes sold through the OTC screen.

To facilitate the sale of DC and PSO backed CfDs beyond the start of the I-SEM the DC and PSO standard contract form should be modified to contain a clear and unambiguous market change mechanism; a clause or series of clauses that set out the contractual changes that would be implemented at I-SEM go-live. Suppliers could then reflect these industry standard change clauses in retail customer contracts. This approach would provide certainty to sellers, suppliers and ultimately to end customers.

Energia would strongly emphasise that transitional arrangements are likely to become an issue during the next 12 months. We therefore recommend that finding effective solutions to these transitional issues should be given high priority within the workstream.