Power NI Energy Limited
Power Procurement Business (PPB)

I-SEM Detailed Design

Forwards and Liquidity Discussion Paper

SEM-15-010

Response by Power NI Energy (PPB)

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Power Procurement Business

Introduction

PPB welcomes the Regulatory Authorities engagement with market participants in the development of the I-SEM and particularly welcomes early engagement and the opportunity to respond to the Discussion Paper in relation to Forwards and Liquidity in the I-SEM. The forward market is particularly important as it is the basis of pricing for the majority of customers.

We believe this approach of early engagement and the publication of a discussion paper to seek input on the scope of the areas that need to be considered in a workstream should be utilised for all the upcoming major market design workstreams that are yet to commence e.g. Market Power, CRM, DS3.

General Comments

PPB's response to the consultation on the HLD of the I-SEM[1] and in particular the Baringa attachment that was included with the response[2], that considered how to promote forward liquidity and mitigate market power in the I-SEM, highlighted our concerns on the issues of forward market liquidity and market power and the Baringa report identified a range of measures that could be employed to help address these issues and which we believe remain worthy of consideration, and which we draw upon in our comments below.

Establishing what is a limited and illiquid forward market in the SEM has been a challenge given the small size of the market in Ireland, the degree of market power in the market, and the increasing scheduling uncertainty as wind penetration grows. These market features remain and with the added complexity of a splitting of the energy markets under I-SEM, early consideration of the forward market and liquidity issues, alongside the detailed design of the energy markets and consideration of market power, is essential to help deliver market arrangements that provide viable risk management opportunities for market participants in an efficient manner.

[1] SEM-14-008
[2] Titled "Promoting forward liquidity and mitigating market power in the I-SEM

Comments on the questions raised in the Discussion Paper

Lessons learned from the SEM

The paper generally captures the areas that have influenced the liquidity of the forward market in the SEM. A key consideration in the SEM has been that participation has largely involved participants with physical positions in the market who are hedging for their "own use". This together with the focus on regulated forward contracts (DC and RoI PSO) has resulted in concentration on these volumes, when there should be greater focus on the overall volumes sold by the dominant portfolio generator in the market. Analysis of the hedging volumes relative to MSQ volumes may be insightful in this regard.

Scheduling risk is a major issue in the SEM and is particularly the case for PPB[3] where over the last 3 years, its units are generally the marginal units whose MSQs are most volatile and depend heavily on the wind generation. Hence renewable intermittency is effectively cascaded and replicated for an increasing number of generating units in the market, which is a particular problem for smaller generator participants.

The development of the I-SEM is unlikely to relieve any of the problems experienced in the SEM and indeed some of the drivers could be even more problematic. For example, in addition to scheduling risk caused by intermittent generation, there is increased scheduling risk in the DAM through reliance on Euphemia which does not accommodate complex bids and from all the evidence available to date, is likely to result is a higher scheduling risk than existed in the SEM. Further the scope for TSO interference on energy schedules through early non-energy actions may also increase scheduling risk which we would expect will be reflected back into the forward market.

A further negative impact may arise from the complication of the proposed ROs. This will need to be taken into account by generators who hold ROs (to avoid being doubly exposed) but generators without an RO would not require the same structure of CfD (and nor would assetless traders if they were to ever participate in the market). This additional complexity may similarly reduce the availability of forward contracts in the I-SEM.

There is also a risk the I-SEM forward market could result in higher overall collateral costs than is required in the SEM (where both sides to the transaction do not always provide collateral, and where Credit Ratings, or

[3] Note there are a number of inaccuracies in the discussion paper when referencing PPB. PPB has had no association with NIE since 2010 and the value of the GUAs has no bearing on the volumes or prices of the CfDs PPB sells

other measures are accepted to reduce the requirement for collateral) which may ultimately affect liquidity and may also be reflected in customer prices.

PPB considers the priority issues to be the increased scheduling risk with increased uncertainty of scheduling in the market timeframe against which forward CfDs are referenced and the issue of a potential increase in collateral requirements (for example PPB does not provide any collateral for CfDs it sells in the SEM).

Specification/Nature of Forward Products

We expect the current range of CfD products will initially be sufficient for the energy market. However, as mentioned above there may be variants of these depending on the interaction with the ROs proposed for the CRM.

The duration of the various products may be an issue and the feedback we receive is that suppliers would like to hedge further out on the curve and the benefit of rolling auctions or trading opportunities that hedge the following quarter is not obvious.

A key issue will be the transition from the SEM to the I-SEM. Suppliers will naturally want hedges to straddle the markets yet pricing may be difficult for that period and hence liquidity could be affected for this period.

There may also be a need for additional risk management products related to the ROs to provide options or other products to enable participants to manage outage risks and subsequent exposures under the ROs.

Nature of participation, including Market Participant obligations

The I-SEM will continue to be dominated by ESB both from a generation and supply perspective and even with ringfencing of these businesses, the design of the I-SEM is favourable to participants with a large, diverse portfolio and is even more susceptible to market power than the existing SEM. In this context, the option to require such large participants to provide a Market Making service would both enhance forward market liquidity and at the same time help mitigate market power. Hence the imposition of Market Making obligations should be seriously considered.

In addition, such an arrangement could, over time and subject to success, reduce the regulatory burden for the RAs by removing the need for extensive analysis of volumes and prices that the RAs currently undertake. A market making approach is likely to provide greater transparency on pricing and provide for easier ex-post review. However, it is unclear whether a market

making obligation on its own would initially be sufficient and a lot would depend on the form of the obligation (e.g. in relation to products, volumes, prices, spreads, etc.). It may therefore be prudent to establish the I-SEM with a wide range of mechanisms available (including DCs) some of which could then be reduced or ceased should a measure such as the Market Making obligation be successful.

It would be worth reflecting on and drawing upon the experiences of the utilisation of such arrangements in other markets to inform the analysis of what is most appropriate for the I-SEM. However, it is likely that any obligation will need to be strictly mandated in the I-SEM.

Any requirement for small party access may be displaced should the market making arrangement create sufficient liquidity in the market.

Interactions with Market Power Mitigation, including Directed Contracts

As we noted earlier, a key consideration and determinant of liquidity is the absolute volume of forward contracts available and if DCs merely displace other forward contracts without considering the overall volume then there may be little impact on the overall forward market and many of the existing liquidity problems will persist.

There is clearly a very close linkage between Forward Market Liquidity and the mitigation of market power. As noted above, sufficient market making obligations could potentially offset the requirement for directed contracts but this would need to be rigorously assessed and evidenced as the dynamic would depend on the form of any market making obligations, for example in relation to products, volumes, timing, durations, price spreads, etc. Again as we note in the previous section, it would be prudent to commence the I-SEM with a range of tools available to mitigate market power and enhance liquidity, and their ongoing requirement and utilisation can be assessed and revised as market experience evolves.

It would also be useful to draw on the experiences in other markets although such analysis must recognise the uniqueness of the I-SEM market in terms of size, dominance of both the wholesale and retail markets by a semi-state participant, and with such ambitious renewables targets that will be largely fulfilled by intermittent wind generation. Hence the solution to both market power and forward market liquidity must be designed in the context of these unique features.

Mediums for trade and trading institutions

The medium for trading needs careful consideration as the various options should be considered to identify whether any particular medium is likely to enhance liquidity and transparency in the market and whether any of the options are more suited to the conditions that prevail in the I-SEM (e.g. small market, mainly physical traders, extensive market power, etc.). It will also be essential to consider the cost of participation both in terms of transaction costs and in terms of the cost of collateral.

The paper expresses the view that lowering the cost of carrying out trades may encourage liquidity. However the current cost of trading is competitive (at an aggregate charge of 2p/MWh) relative to, for example, trading on APX or N2EX in GB although such costs are likely to be less material than the cost of collateral.

With the increased number of markets in the I-SEM, minimising the cost of participation through the netting of collateral must be achieved. Clearly this would be achievable if there were a single counter-party for all transactions (including the CRM and DS3 markets). However, it would be useful to explore options that enable some form of multi-lateral pooling arrangement that could give effect to netting even though the transactions occur in different markets with different counter-parties.

It is also worthy of again noting that PPB has offered the most generous credit terms since the commencement of the SEM, including accepting different forms of collateral and only requiring collateral for executed trades. It is also worth noting that PPB does not provide any collateral to its CfD Counter-parties and the design of any new arrangements must seek to preserve this since any increase would represent a net cost increase that will ultimately be passed on to consumers.

PPB has no preferences as to how or where any I-SEM forward trading is conducted and we consider all options should be explored to find the solution that is most efficient and cost effective for the specific requirements of the I-SEM. PPB, in close liaison with ESB Power Generation and the RAs, led the development of the MTF upon which most of the current SEM forward trading occurs. We consider the assessment of how best to deliver any future trading platform is something that can be determined once the preferred trading medium is identified.

Factors affecting liquidity in the near-term markets

PPB considers that most of the factors that will affect liquidity in the DAM and IDM have been identified although there is one key area that is missing and that relates to the role and actions of the TSOs in the Balancing Market and particularly in relation to the consequences of early and/or non-energy actions. As was discussed in the recent Energy Trading Arrangement workshops, with the parallel operation of the IDM and BM, there is significant scope for such TSO actions to have a material impact on what under the HLD is supposed to be an unconstrained market with the final stage being to compensate participants who are constrained for non-energy reasons on a pay as bid basis. There is a high risk the TSO actions could impact on liquidity in the IDM although this will depend on how the Energy Trading arrangements develop.

A further issue relates to how renewables decide to participate in the DAM and IDM markets. There may be many factors that affect this including the support arrangements, the design of the BM and the volatility of pricing in the BM, and on the decisions in relation to priority dispatch and curtailment. This impact is likely to be uncertain and it may be fluid within the market and it could be a dynamic feature in the I-SEM. As we expressed in our initial feedback to the ETA workshops, it would be beneficial for the consultation on these issues to be supported by modelling of the potential dynamics of participation across the three energy markets and this would help inform whether such dynamics could impinge on liquidity in the ex-ante markets.

It is also worth noting that while the discussion paper indicates that the granularity of IDM products should match the settlement timeframes, all the products in the DAM and IDM are hourly products yet settlement is proposed to be on a half-hourly basis. Under the initial BM proposals, this will impose imbalances on participants.

Design of I-SEM Financial Transmission Rights

Our expectation is that participants would be seeking to use FTRs as part of their risk management strategy to hedge prices. In order to equate to an I-SEM forward hedge, the participant would need to put in place both a hedge in GB together with an FTR. It would therefore seem most likely that a 2-way FTR, i.e. an FTR Obligation, would be the most useful instrument and would therefore generate the most liquidity.

We expect the FTR would be treated no differently to any other CfD and hence would be governed by the same legislation. We agree that FTRs would be subject to the EMIR obligations, including reconciliation and reporting. We are less clear on the obligations under MiFID II but these would clearly need to be investigated and understood.

It remains unclear how losses will be treated in the DAM but we would expect that transmission losses will need to be factored in to the FTR to align with the underlying treatment of losses in the DAM (assuming that is the reference market as the IDM has no clearing price).

Allocation

While the FCA Code requires a single centralised platform, we would expect that the functionality of the platform should be designed to ensure the platform meets the requirements of participants in the I-SEM. However, we consider it would be unwise to rely on the developers to design solutions that meet the needs of the I-SEM as it is likely their focus will be on the standard European requirements and also that it will be dominated by the sale of physical capacity rather than FTRs.

Firmness

The concept of firmness is vital to the risk allocation and hence usefulness of the FTRs as part of a participants risk management opportunity and passing the risk on to users will likely have a negative impact on liquidity in the market. It seems clear from the argument in the EU that the owners and operators are seeking to impose the risk on users while ACER believe the risk should sit with the owners. Eirgrid, as owners and operators of the East-West interconnector are conflicted and will inevitably seek to pass on the risk to users. Hence the RAs must take the lead in this area to ensure a fair outcome is reached that does not erode liquidity in the I-SEM.

Revenue Adequacy

It is not clear why revenue adequacy of interconnectors is deemed to be an element of the Forwards and Liquidity workstream. Revenue adequacy is an issue for all market participants in relation to the development of the overall I-SEM arrangements and whether they will provide a reasonable return to generators such that the market is sustainable and security of supply is maintained. However, this can only be considered in totality and not just in relation to one element.

The relevance of firmness and ramp rates is unclear as such risks are no different to the risks any other generator takes on when they sell a forward CfD where the products are standardised and do not take any heed of generator unavailability, scheduling, ramp rates, etc. It would therefore be discriminatory to only seek to protect interconnectors from such risks and we believe there is a requirement to assess revenue adequacy for all participants, considering the full range of potential revenue streams (energy markets, CRM, DS3, renewable support mechanism).

Market Power

A general concern with the I-SEM is that it increases market power and extends it across the different energy, CRM and AS markets for those participants with a dominant position in the market. In light of greater interaction between the I-SEM and GB markets, the market power of I-SEM participants who have dominant positions in the GB market (i.e. SSE/Airtricity and Centrica/BGE) will also need to be considered.

We agree that the impact of FTRs should also be assessed to identify if they could further extend market power and to determine whether measures such as limits on capacity holding are required (as was recommended by Baringa).

Interactions with CfDs, Reliability Options and Renewable Certificates

The discussion paper mentions the possibility of a party needing to make several difference payments for the same timeframe under a suite of CfDs because of, for example, ROs. Participants could not accept double exposeure and contracts would have to be designed to remove such exposeures since otherwise the party would be increasing rather than reducing risk. If the overlap between contract types cannot be resolved then there will be a real risk to liquidity in the forward market.

Careful consideration of the relationship and structure of different forms of forward products will need to be assessed to ensure they don't compete against each other to the detriment of overall liquidity.

Transitional Arrangements

The indications to date seem to suggest that there would be a complete change to FTRs from the commencement of I-SEM. However this could be a high risk approach, not least should there be any potential for a delay to I-SEM go-live. This approach may also be problematic for suppliers and

customers who will most likely not want a big bang tariff change alongside the commencement of I-SEM.

The scope for having a combination of PTRs and FTRs for a period could be considered. This could help address the issue of continuity of tariffs for customers as such an arrangement would enable suppliers to avoid a cliff-face as they continue to seek to offer continuous retail products. It would also lessen the impact of any late deferral of the commencement date for the I-SEM as it is not clear to us how any FTR could function with the current SEM market. The contractual arrangements for FTRs would therefore need to address what happens should the commencement of I-SEM be delayed.

A further issue to consider will be how potential buyers of FTRs can price FTRs in the absence of any experience of the functioning dynamics and pricing in the I-SEM DAM and this may impact on the timing of any auction of FTRs.